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Jan/Feb 2013

The Central Bank Revolution II – Chasing the Dragon



Virtual Signs

Chasing the Dragon

Credit Dies, Money Flies

Risk (Assets) and Ruin

Viva Las Vegas

Mind the *Margin* Gap

FX Regimes & Gold

Gold Remonetisation (Un)Official

Monetary Singularity

"The market is not an accommodating machine. It won't provide high returns just because you need them."

Peter Bernstein

"All Nations with a capitalist mode of production are seized periodically by a feverish attempt to make money without the mediation of the process of production."

Karl Marx

"Inflation is the disease of money."

Jens Parsson

In the Central Bank Revolution I, we depicted how a new mode of monetary policy has been adopted by developed world central banks. Their new policy adoption is more of the same – that inflationist drug of bank reserve creation, only this time with heightened potency.

Advocates of a school of thought called market monetarism have helped provide the intellectual impetus for potentially even more misguided and misdirected monetary policy which will only continue to exacerbate the growing disconnect between prices and output and that of market valuations and real economic growth.

Policymakers misdiagnosed the root cause of the crisis. We have experienced the bursting of a super-credit cycle. Credit supply has surpassed merely money supply as the overwhelming driver of the business cycle. The credit cycle is the business cycle. The removal of gold as a restraint in 1968 to money creation and in time credit growth, has allowed for excessive proliferation of credit which due to financial innovation has enabled it to be 'money-like' in its use.

The access to credit as *quasi*-money has flooded economies with the ability to drive output higher but at a diminishing rate by driving asset inflation and not price and goods inflation. As we depicted in the *Central Bank Revolution I* -if it had not been for the effects of globalisation on labour and wages, hyperinflation would already have ripped through prices in the global economy.

In this piece, the *Central Bank Revolution II - Chasing the Dragon*, we illustrate how the effects of central bank monetary policy, today, have already distorted the term structure so monstrously that assets have been driven to yields more akin to those of holding money. The yield grab has extended into riskier and riskier assets and structures, resulting in a diminished return profile that is not compensated for by the falling credit quality, and the heightened duration risk. The stage has been set for capital losses, as once again investors indulge in levered products, with suspect collateral value, and invest in plain vanilla assets with no margin of safety.

There is no value in the market place which is engineered by state control of the monetary structure. Investors have begun to treat asset classes as 'money-like', ie relatively riskless. Central banks have engineered this reality. They appear to be implementing portfolio channel theory with success. This is where central banks drive long end rates lower in a hope to encourage investors to seek higher returns in other risk assets – primarily equity markets. The aim is to drive equity prices higher creating a wealth effect that will encourage consumption and in turn encourage businesses to invest in more capital production in response to this demand.

For now all central banks have achieved is greater speculation in financial markets. We believe that real output will not be forthcoming because of the continued overhang of stale credit, and only prices will rise, except this time it will be in price of goods and services which could arrest too an aggressive mover higher in equity markets even though they look ‘cheap’ in real terms.

The greatest economic fight of the 21st century is at hand. Do policymakers continue to encourage credit creation or do they resign themselves to an inevitable collapse of the current monetary system. Either way it

will happen. If they inflate now they will only succeed in postponing economic collapse which will ultimately come about as a boycott of sovereign bonds, which incidentally will render the banking sector, capitalised by such bonds, technically bankrupt. The only debate then is do we experience a deflationary collapse first, followed by more stimulus and then hyperinflation followed always by an economic collapse which is deflationary.

It would appear then that we have two types of crisis but only one outcome. Central banks invariably cause inflation as they plug the often unbridgeable fiscal gap. The desire to close this gap by both the exchequer and the central banks leads policymakers to overplay their hand, with aggressive monetization of government debt leading to much higher nominal prices. Policymakers are clearly embarked on this course of action, injecting more opiates into economic addicts, in a veiled hope that both can reach the state of Nirvana achieved in 'wealth' before the Great Financial Crisis manifested itself in 2008.

The private sector has welcomed such infusions as they have not had to extinguish debt by writing it down, paying it down or even defaulting. The impact of escalated central bank largesse will arrest the de-leveraging process for a time, but with state coffers so impoverished, the banks that are so thinly capitalised by state debt are highly exposed to any new shock to the system. There is no margin of safety for both banks and sovereigns.

Nations and their citizens have become so stimulus dependent and reliant on ultra-loose monetary policy that any withdrawal will be terminal for them. A very real solution and likely the least disruptive in terms of social cohesion in the world, is to back all the bank reserves created with an asset such as gold. An asset that is not corruptible in its intrinsic worth as it cannot be printed.

Policymakers may well be vying this potential in the developed world but if they are not it is clear the new 'Cold War' is the 'Gold War' whereby China, Russia and some emerging economies have begun the slow migration to gold backed currencies and bilateral trade agreements excluding the West.

"As the international community attempts to take on these challenges, gold waits in the wings. For the first time in many years, gold stands well prepared to move once more towards the centre-stage. This could be the start of an immensely important phase in the history of world money." OMFIF

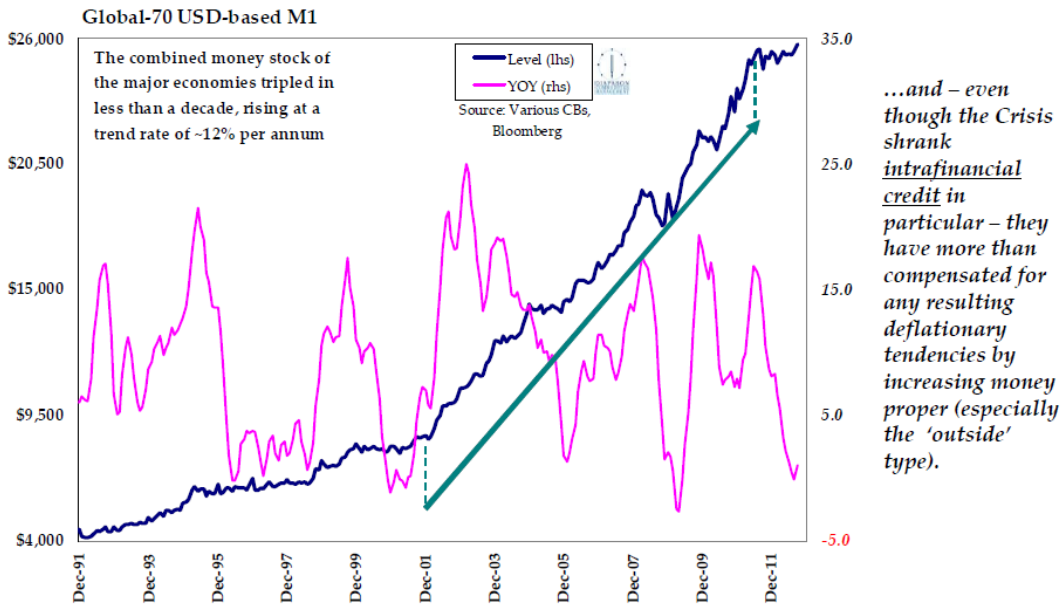
VIrTuAL Signs

The economy is like a drug user and the central bank is its dealer. Central banks have been administering their very own prescription of methadone (a state administered heroin-substitute). We know it as 'easy' or 'printed' money injections.

The symbiotic relationship between the central bank and government enables monetary injections to fund both the economy and the welfare state. Unfortunately our economic system has become so dependent that any sudden cessation of these money injections will lead to extreme withdrawal symptoms. This is the predicament we find ourselves in today.

Individuals are the economy - they determine the exchange of goods and services that promote production and savings. However, individuals have accepted the state's easy money to consume today rather than tomorrow, paid for out of borrowing from the future rather from any savings today.

Asset price inflation up until 2007 was a manifestation of this 'easy money' drug, which provided increased wealth as homes and equity prices in particular rose. This wealth growth was an illusion, which became all too apparent when prices collapsed in 2008 and early 2009. Such wealth funded on borrowing ordinarily would have exacted irreparable losses on irresponsible debtors and lenders alike. This was not to be the case.



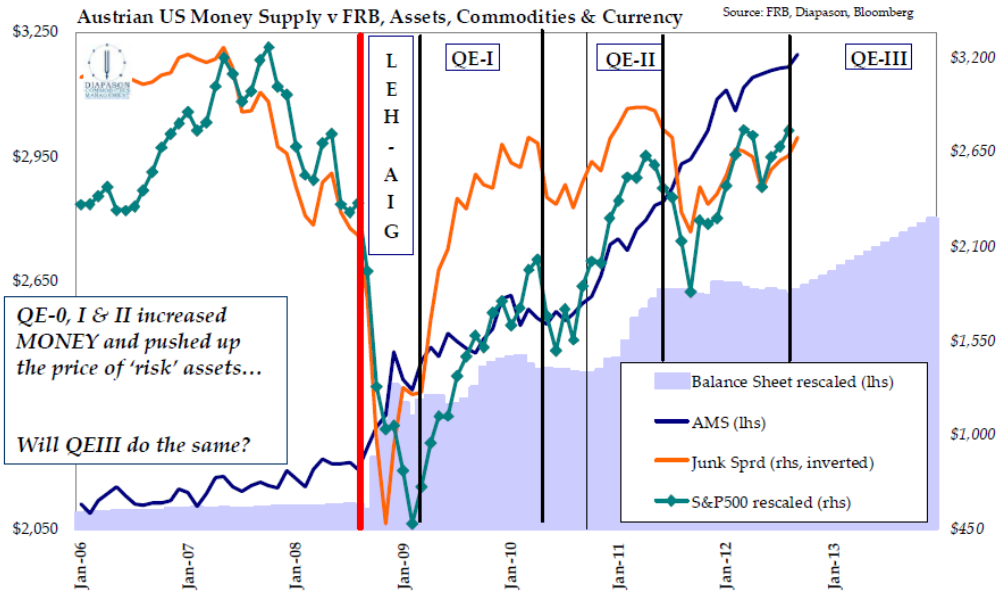
Source: Sean Corrigan, Chief Strategist - Diapason Commodities

Policymakers fearing a sustained global economic meltdown accompanied with social and geopolitical instability resolved themselves to circumvent this potential outcome by injecting huge doses of money into the economy to stabilise it.

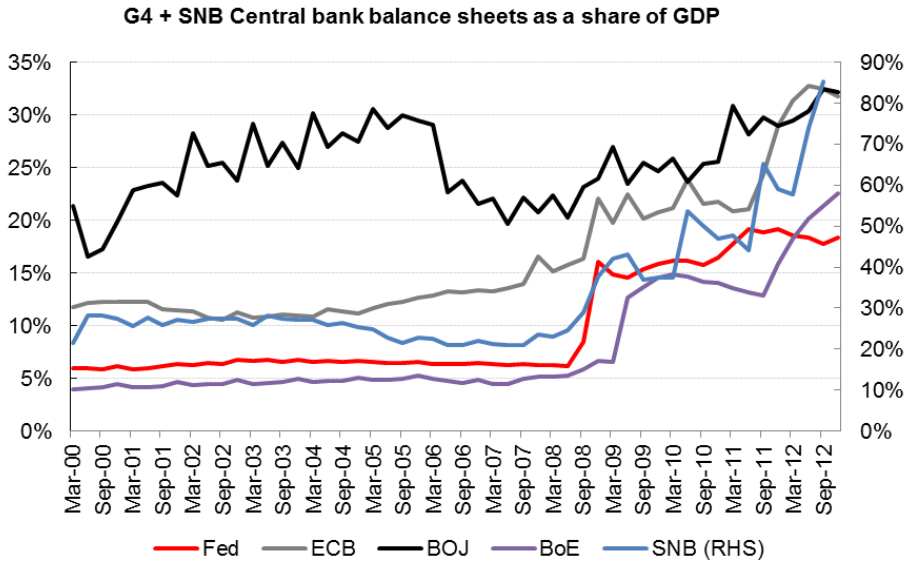
We would argue that back-stopping the system was a wise and prudent step if it is was just a one off event. It bought time for clearer heads and an understanding of the risks individuals had taken. Those very same individuals would then have been able to adapt more safely to a new economic system based on less borrowed consumption and less reliance on the State.

An uncontrolled withdrawal from drug participation can kill the patient. A patient needs to be weaned off a drug. If the economy had been deprived abruptly of money to restore the balance then it would have died. Similarly the economy needs a controlled withdrawal of money allowing individuals to attempt more self-

reliance. Unfortunately today we are about as far away from this reality as a 'raver' on acid. The monetary doses are growing larger but more ineffectual other than to create complications for the future. The future for once is oddly predictable if past patterns are indeed repeated (or rhyme).



Source: Sean Corrigan, Chief Strategist - Diapason Commodities



Since 2008 the economy has been like a patient in an ICU receiving a 'mainline' into its vein. The vital organs responded - the markets and asset prices rebounded but the patient - economy - remained largely sluggish. It has been lethargic and unemployable ever since. The disconnect between the seeming rude health of the vital organs - the stock indices, commodities, and bonds, and the reduced volatility in their output has emboldened central bankers to up the dosage, so resolute are they that such vital signs are those of a body restoring itself to health.

So anaesthetised to the on-going drip of 'virtual' money into our veins that we have begun to forget about the process of making money through production and begun to hanker for our state administrations of methadone to satisfy are cravings for a 'better' standard of living; but we are all having to take greater risks with our own (or borrowed) money to achieve this.

Chasing the Dragon

The arch-dealer Ben Bernanke himself believes that adverse shocks to the economy may be amplified by worsening financial markets (namely equity markets). In essence there is a feedback mechanism between both the real economy and financial markets which reinforce each other's state of being. We agree with this concept. Where we disagree with Bernanke is the need to drive up asset prices to create a wealth effect which signals to agents in the economy that conditions are stable.

If the antecedent of higher asset prices is a function of nominal price rises, ie those driven by money supply, then this helps create a pyramid of credit underpinned by assets where the income needed to fund them is not sufficient. Then this merely sets the stage for a greater economic collapse feeding on this reflexive behaviour of economic agents both in the financial markets and the real economy. Prices will rise, not real output and this will erode private sector margins, killing growth.

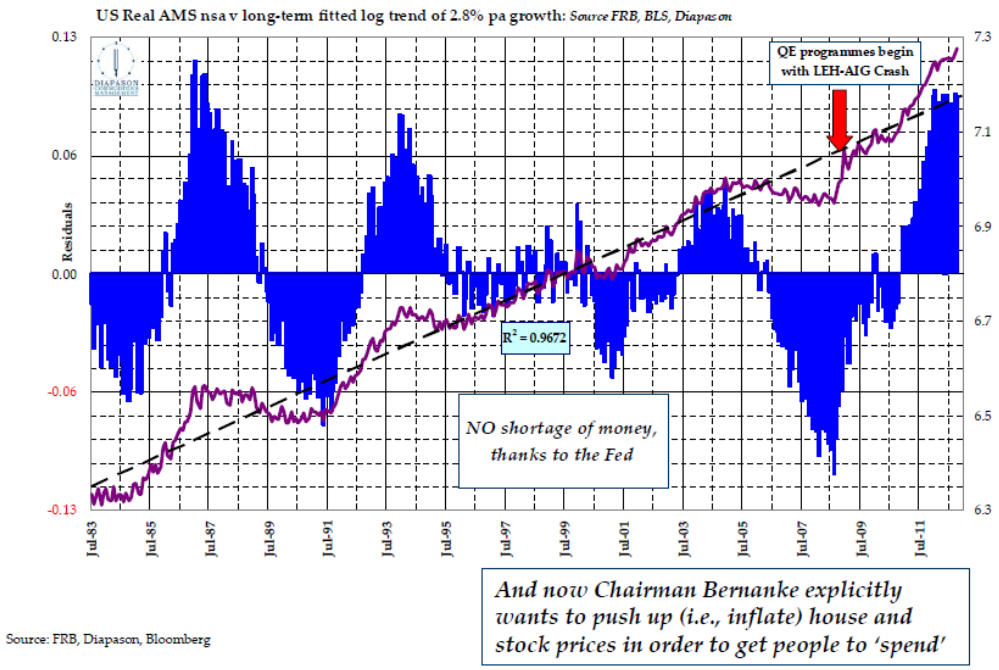
The impact of zero nominal interest rates to fund central bank 'easy' money has merely induced financial participants to look for higher income or yield by which to meet investment objectives and or desired rates of return needed to maintain the rising costs of living. (Nominal wages have not kept abreast of inflation.) Unfortunately this has entailed taking on greater risk.

Cantonese drug users speak of 'chasing the dragon' referring to the long inhalations of vapour heated from morphine and heroin they take in the search of the ultimate high (the dragon) but which never quite delivers, remaining teasingly elusive. Drug addicts observe a psychological and even physical tolerance that exhibits a *diminishing return curve* in the user's enjoyment of a drug. The most heightened return is usually achieved in the novel days of usage but with the positive psychological effects diminishing there becomes in time perilously negative effects that manifest in real mental and physical harm for the user who is now a patient to the cause, as the user fruitlessly begins to chase the by now increasingly elusive highs by upping successive dosages to replicate that first initial state of euphoria.

And so the metaphor of the dragon chaser seems so apt for those 'chasing for yield'. The initial hit of the drug user being analogous to the best return the fixed income investor can achieve; but as with the diminishing return profile for the drug user so it is for our income return chasers. Invariably a drug user will embark on higher doses or move down the quality spectrum for cheaper but more potent opiates in the vain hope of finding the dragon. In the same vein as income falls, the investor will search for higher returns by moving along the credit spectrum taking on more risks for only slightly higher yields.

The investor begins to stretch for yield, swapping one bond (one drug) for one of lower quality but with instant if not short-term highs. But the warnings are there for both the drug user and investor. The high is better but short-lived and comes with a higher risk as impairment to the drug user's long-term if not short-term health is heightened. The investor similarly experiences poorer substance quality and likelihood of risk to their financial health if they get the wrong dose. Ruin is never far away.

Just like the drug user migrating down the quality spectrum or leveraging up the doses of such impurities, so the yield chaser migrates down the credit spectrum, exposing themselves to a leveraged and impure product that can meter out untold physical and financial ruin. Both dragon chasers will yield psychological and physical harm, for the individual's psyche in our Utopian world of consumption assigns so much value to his or her sense of being, based on their associative monetary health.



Source: Sean Corrigan, Chief Strategist - Diapason Commodities

Unfortunately so imbued are Central banks with their success at maintaining something akin to the status quo and with the addicts clamouring for more, so they can fully regain their wealth status, they have been emboldened to do more. Unfortunately each new injection of drugs appears to have a diminishing impact.

Credit Dies, Money Flies

This entire risk taking is then merely a function of the amplification of money and credit in the wider economy. Credit-induced boom and bust cycles are a not a new phenomenon but what makes the 2008 crisis so remarkable is the magnitude of the credit expansion that fed it.

Even more extraordinary is the policy response to infuse ever increasing amounts of money into the financial system to reignite growth. The reality is far starker, as credit is dying, money is flying, to try and arrest its collapse.

The state has in effect chosen to fight the collapse of credit by underwriting private balance sheets, namely the banks, pension and insurance companies *by issuing more debt,* injecting money and making purchases of both private and public debt to keep yields low.

This has prevented assets clearing to their 'true' market value. The base money increase prevents banks' troubled asset prices from adjusting to lower levels. For example, mortgage-backed securities worth billions have still not been placed at market-clearing levels with private investors, instead remaining artificially supported either directly by central banks or indirectly by the financial sector.

Easier credit availability sourced by new sources of collateral (think 'securitisation proliferation') and lengthened repayment schedules have led to the production of goods underpinned by effectively less cash, and higher debt backed by spurious collateral.

This is also a problem because the collateral that underpins these loans is not valued in line with the real market, but is held at opaquely valued prices on balance sheets. The asset write downs are not being taken, as clearly evidenced when we examine how the Spanish financial sector values property. Value is overstated.

The impact of lower rates from QE creates many distortions in the economic and financial structure. Company pension funds must discount future liabilities at a lower rate, driving asset/liability mismatches higher. Company actuaries demand more bonds (assets) to cover the higher liabilities.

These low rates have also masked the extent of developed country problems as they have forestalled deleveraging which is essential if the economy is ever to grow productively absent of debt burdens.

Risk (Assets) and Ruin

It is our contention that the act of increasing money in the system has resulted in assets exhibiting more 'money-like' behaviour and more 'equity-like' risks. The impact of a distorted term structure has forced investors to reach for yield driving prices so high that they yield no return just like money. Of course real rates are negative and so the corporations should easily be able to deploy 'capital' into operations that yield a higher return and be able to return cash-flow to investors. Unfortunately the capital that underpins these operations has an elevated and unrealistic value, with credit pyramid upon liens of credit supported by suspect collateral quality and hence value.

Asset response to Quantitative Easing

	1yr before QE1	During QE1	Between QE1 and QE2	During QE2	After QE2 before Twist	Operation Twist	During QE3	During QE4
USD/TWI	22.2	-10.3	-4.2	-3.5	2.7	1.8	1.4	1.0
USD vs EUR	16.7	0.0	-2.3	-3.3	5.6	4.9	-2.3	-1.2
USD vs JPY	-1.4	-2.5	-14.2	-0.1	-5.5	1.8	11.5	7.9
USD vs AUD	28.7	-34.7	-7.2	-7.2	4.7	-4.3	0.7	0.9
10yr nominal yield	-0.5	1.3	-1.2	0.6	-1.3	-0.2	-0.08	0.00
10yr real yield	0.8	0.27	-1.16	0.27	-0.69	-0.63	-0.11	0.20
Inflation expectations	-1.3	1.1	-0.1	0.3	-0.6	0.4	0.03	-0.20
10yr - 2yr yields	0.1	1.09	-0.53	0.46	-0.93	-0.15	-0.01	0.23
S&P500	-41.5	47.2	0.5	10.6	-10.3	23.1	-0.7	6.6
CRB Index	-46.0	27.9	9.2	10.9	-3.5	-1.7	-6.5	1.2
Gold	-6.9	18.4	20.0	10.5	21.5	-2.8	-3.3	-3.9
Oil	-55.3	73.4	-1.9	13.6	-8.3	13.1	-5.3	4.5
VIX	15.0	-22.5	4.4	-5.1	17.0	-21.5	2.2	-5.6
CVIX - 3m implied	4.8	-6.6	1.8	-2.1	3.0	-6.5	-0.1	1.1
MSCI Eastern Europe	-68.6	113.6	-2.2	15.2	-24.6	3.1	2.1	1.2
MSCI Far East ex Japan	-36.1	59.7	9.4	0.7	-14.3	6.1	7.6	2.5
MSCI Latin America	-35.8	57.3	4.2	-8.9	-8.5	8.2	4.0	-0.9
MSCI Pacific ex Japan	-48.5	89.7	6.1	2.6	-15.1	10.6	6.3	6.5
MSCI World ex USA	-47.5	62.3	2.7	7.2	-16.3	12.0	5.0	3.6
Copper	-54.6	109.6	5.8	10.8	-10.7	-1.5	-2.3	3.6

Source: Deutsche Bank

Investors need to comprehend the short-term impact of easy money that drives asset prices higher is merely a form of misallocation of capital. The structural overhang of too much credit in the system has rendered any sustainable income from any industries likely unsustainable, for the reasons just cited. And indeed the creation of new money at these negative real rates merely postpones the long term disruptive effects of too much credit.

Variations in credit, which we have described as now being money-like, its volume of and constituency of the credit pyramid (public or private) are crucial both to the understanding of the business cycle and to the asset pricing it generates.

As Sean Corrigan of Diapason Commodities puts it - "variations in the rate of monetary change, especially in real terms, are intimately related to swings in economic activity and the 'Risk On'/'Risk Off' (RO/RO) binary nature of increasingly cross-correlated financial markets."

This RO/RO behaviour has become accentuated by investors, particularly hedge fund managers who have undergone a learned adaptive response. In trying to maintain returns and not lose too much in response; a

reaction to their investors lack of risk appetite, they have reacted to liquidity injections and withdrawals like Pavlovian dogs.

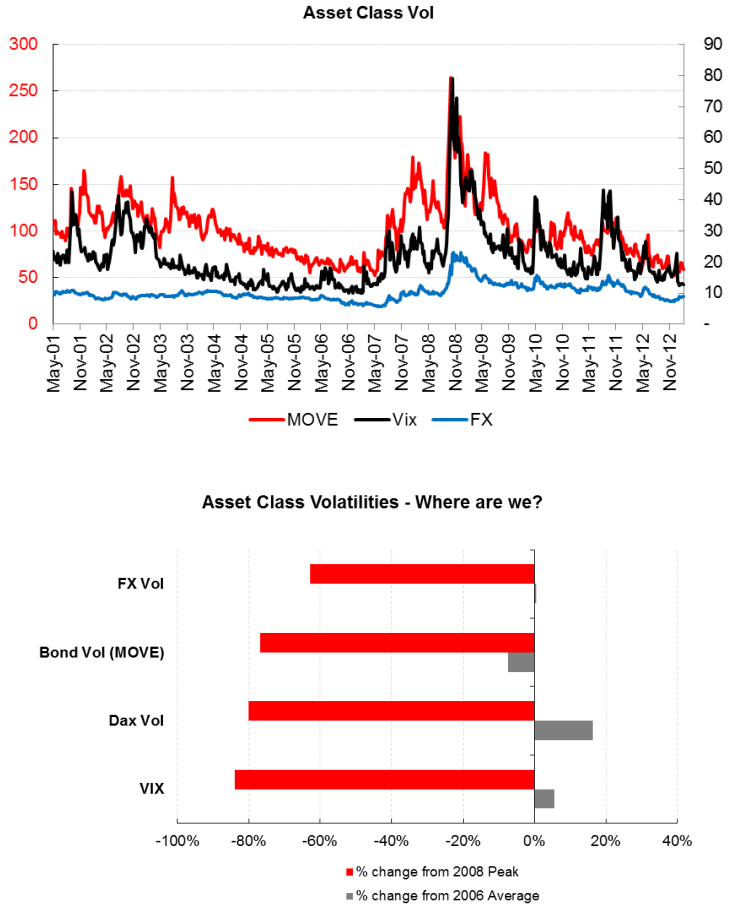
Where once the act of QE itself led to risk on by market participants policymakers merely have to utter a veiled reference to more QE or not and the market flies from anticipation and then over commitment and then to severe withdrawal when it sees no follow through is provided. This has worked both ways, the mere hint of tighter conditions or cessation to QE has led to mini-death spirals in asset prices, but the overall trend has been higher.

Central banks have so dosed up investors that just like a drug user under the influence the markets seem impervious to the risks and have to take on investing at higher and higher prices. In reality investors have been taking on even more risk by selling volatility premia against assets they have owned to garner yet more yield. This is great right up until the 'unknown unknown' appears. As Mike Tyson said "everyone has a game plan until they are punched in the face".

Volocaust

We expect global asset price volatility to rise throughout 2013, as monetary largesse shifts from depressing market volatility to igniting it. Liquidity had stabilised and caused price movements to be contained. Likewise, yield hunters sold option premia to enhance return, safe in the knowledge the central banks had their back. Stability breeds instability and with asset price distortion manifest we expect to see disruptive price movements and heightened volatility.

Volocaust - Move and VIX index



Souce: Variant Perception

We would argue that the market has placed faith in the short-term ability of central banks to protect the downside by providing yet more liquidity. Although front month volatility looks very low, the curve steepens out to 1 year, but even this is historically low.

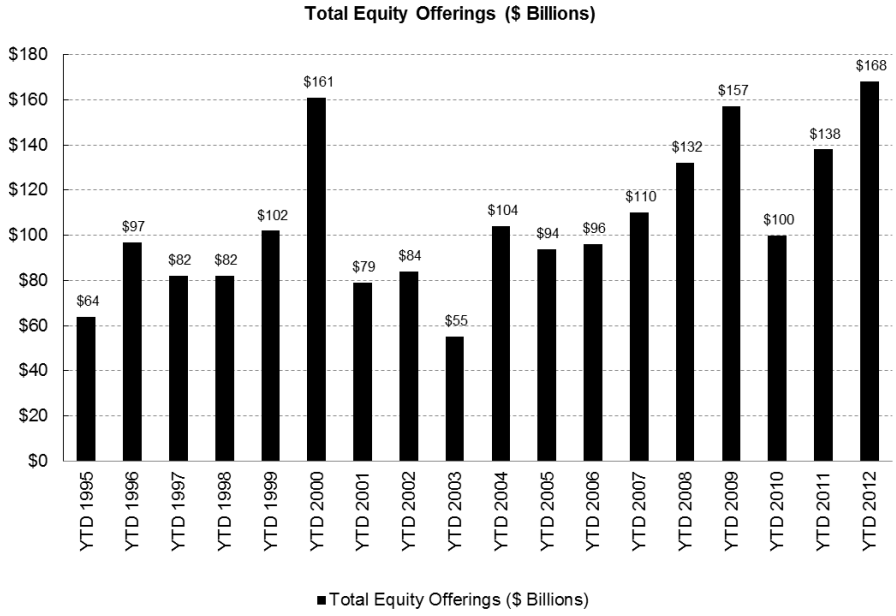
The respected investment manager Howard Marks of Oaktree capital remarked:

> If the global crisis was largely the product of obliviousness to risk - as I'm sure it was - it's reassuring that there is little risk obliviousness today. While psychology is distinctly not bullish investors are acting bullish.

Whilst we would agree in the main with this comment, we would add firstly that many investors have themselves misdiagnosed the crisis that has befallen us and so are mistakenly encouraged by rising markets as a sign that growth prospects are on the up. Likewise with liquidity indicators on the rise, investors have hoped that cyclical growth prospects could spur something in nature of a longer duration and magnitude. If they understood that this output rise is merely a function of nominal price growth and not real capital growth they would be more sanguine.

Lastly, we believe there is an understanding that central banks are attempting to reflate and that the portfolio channel effect is working. The central banks have succeeded in 'crowding' out return expectations in some asset classes to such an extent that ***the 'yield' chasers have now turned 'return' chasers.*** They are now ploughing headlong into asset classes which traditionally exhibit more risk, but as risk premiums have been cauterised by lower discount rates (the ZLB) so they have become to look attractive on a relative basis.

Equities are quite possibly rallying in nominal prices due to a reflexive reaction to the central banks forward guidance, ie expectations of low rates for longer, which has led to the issuance of more corporate debt. Yet despite record equity issuance, we have seen a rise in equity buybacks (or expectation of) helping offset some of this new supply of equity. However in the main there have been more buyers willing to pay up than sellers needed to sell at lower prices.



Source: Thomson Reuters

Stock markets are not a sign of an economy's vital health and they say nothing about the value of the numeraire; they are just a price. Price is the noise and value is the signal. So do they have value?

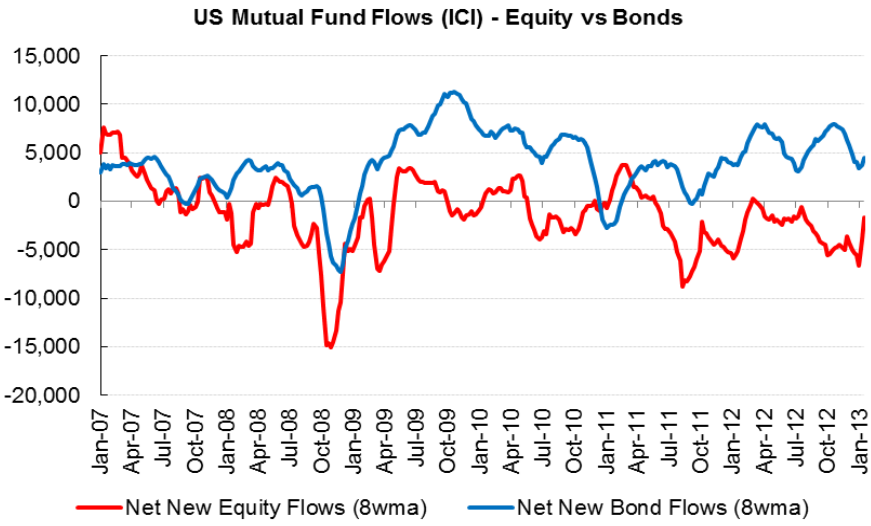
Fixed Income and Equity

We dislike fixed income intensely and we like specific EM equity indices and we are wary of US equities, especially the Nasdaq 100. We wish to own Japan equities vs US equities.

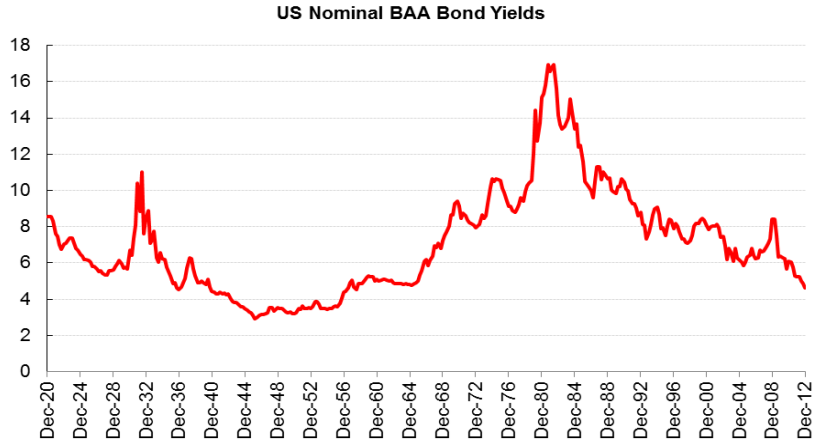
Bonds are traditionally considered safe assets. Today we would consider that statement an oxymoron. Put another way 'riskless' has become risky. In truth that is probably applicable to all investor classes to some varying degree.

US Retail Investors - Chasing the Dragon (Return seeking by 'yield grab')

Monthly net mutual fund inflows ($bn)



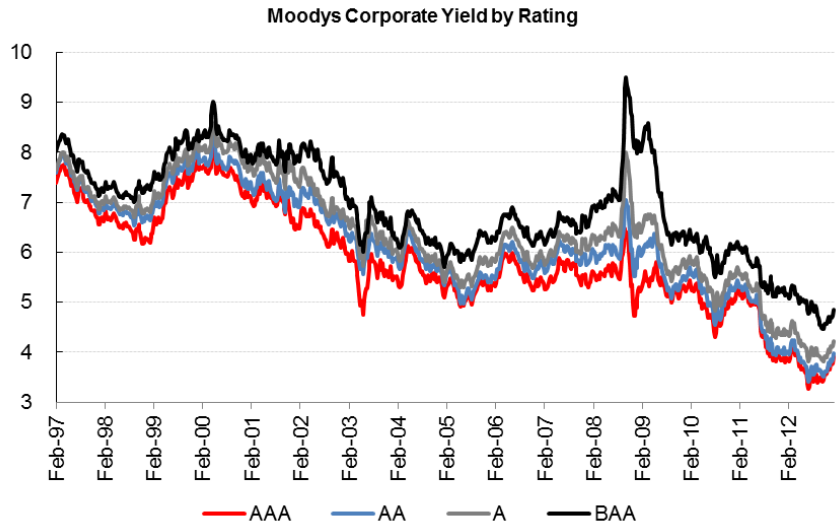
Nominal BAA bond yields record lows



BAA bond yields and spreads are at a 55 year low, similar to the Great Depression levels, having surpassed the pre-crisis lows of the past three decades.

As Japan showed, the early years of a migration to ultra-low rates are very attractive for fixed income assets as the market delivers a one-off increase in capital values. Post-2009 returns in fixed income assets have been exceptional: sustaining them has heightened risks, not least of all because investors helped fund Japan by borrowing in yen to invest in higher yielding assets abroad. This prevented rates backing up in Japan.

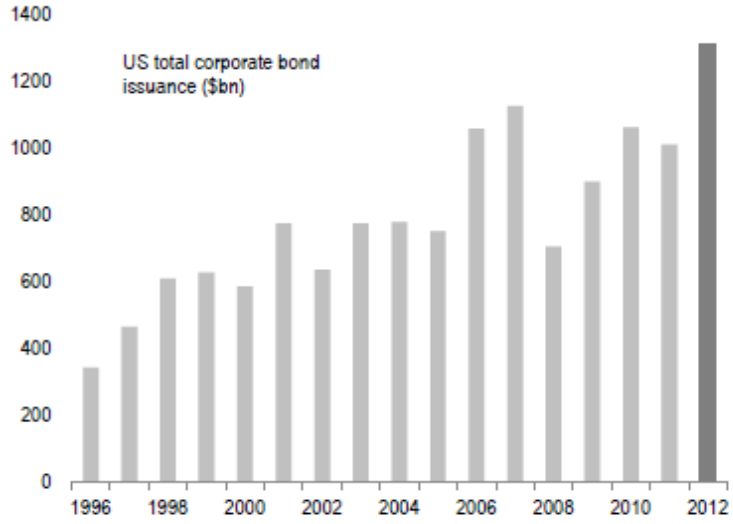
Today this international 'bond' yield arbitrage is not really an option as most countries have converged on the zero bound and eradicated risk premia for those investors that require some margin of safety.



US Corporate and High Yield Debt Issuance - Record high 2012

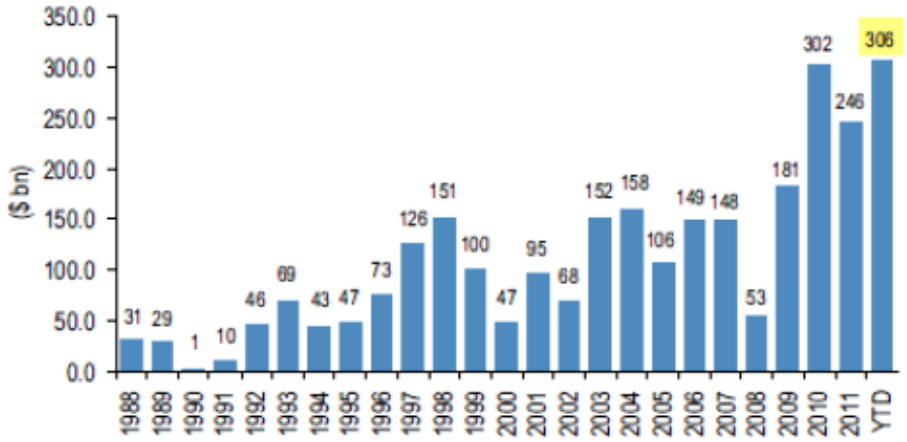
Investor appetite has been high as yields have fallen, in spite of record supply. Issuance is in nominal terms so more money equals more issuance, or is it just a yield need?

2012 Record US Corporate Bond Issuance



Source: SIFMA, CSuisse

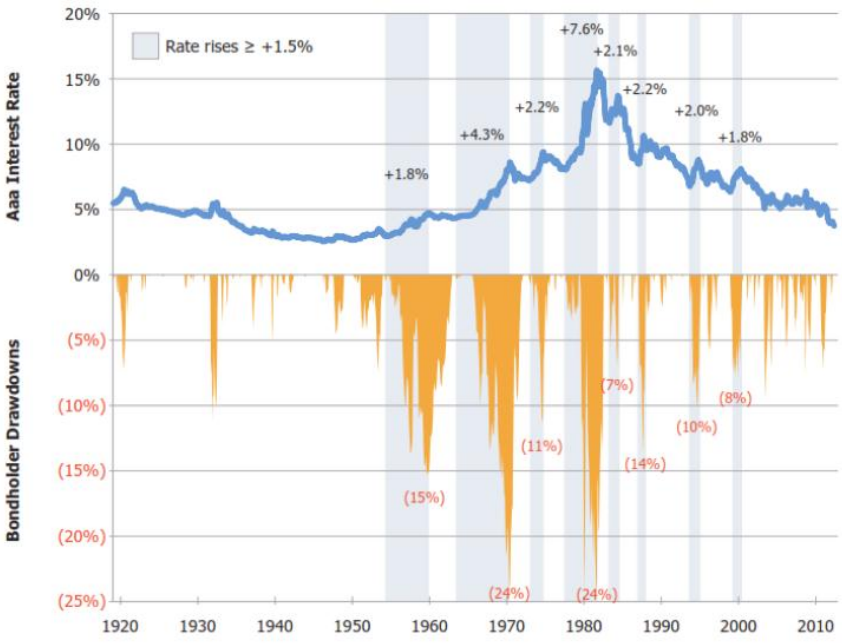
2012 Record - High Yield Debt Issuance



Source: Dealogic

At these yields, there is no room to withstand a 'shock' such as higher inflation, 'virtual' growth or default fears. There is no 'margin of safety', for even if an investor manages to hold these to maturity they are guaranteed a 'real' yield loss, ie capital and income return adjusted for inflation.

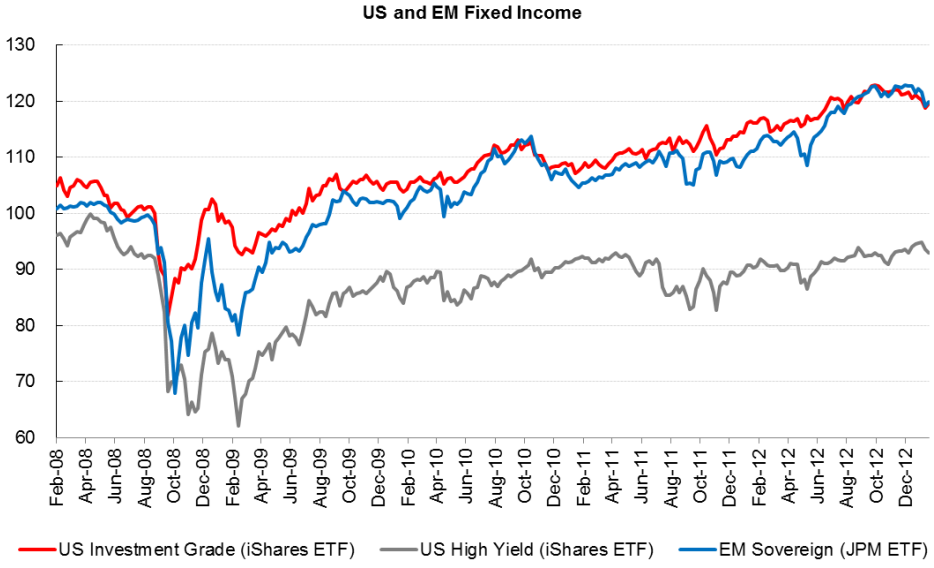
The Biggest Drawdowns on Aaa-rated Bonds, 1919-2012



Source: Welton Investment Corporation

A simple chart says it all. Bonds can exhibit high capital losses, when sensitivity to a small yield change has a higher impact on price at very low yields.

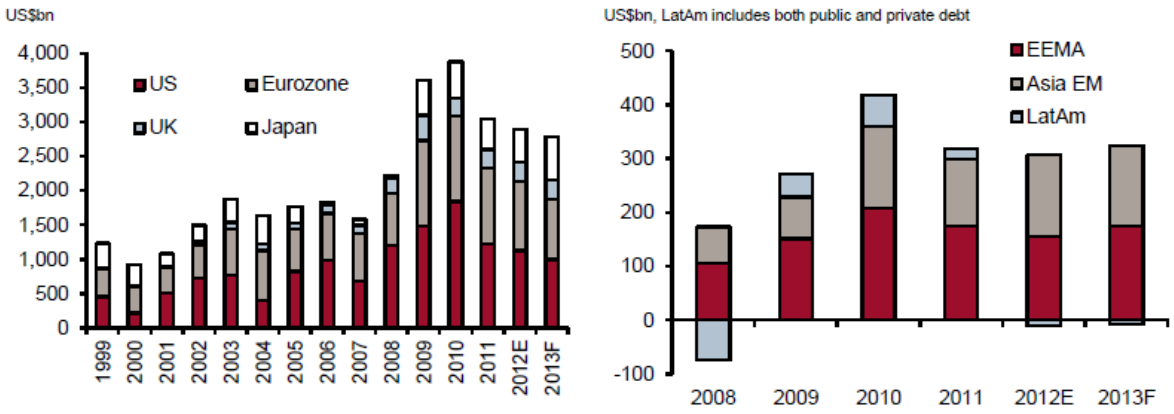
EM Bonds



One caveat for the time being is that as things stand in 2013, there will be a dearth in the supply of fixed income securities which could be supportive and prevent a significant back up of rates at this stage.

Credit Suisse forecasts net issuance of government securities to total around $3.1 trillion, 90% of which will be issued by G3 nations.

Global Government Issuance - A Dearth of Supply in 2013

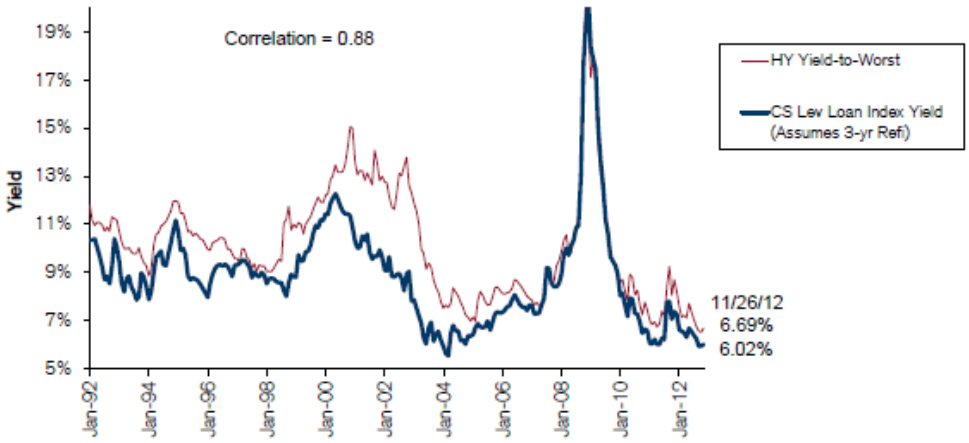


Source: CSuisse

Viva Las Vegas

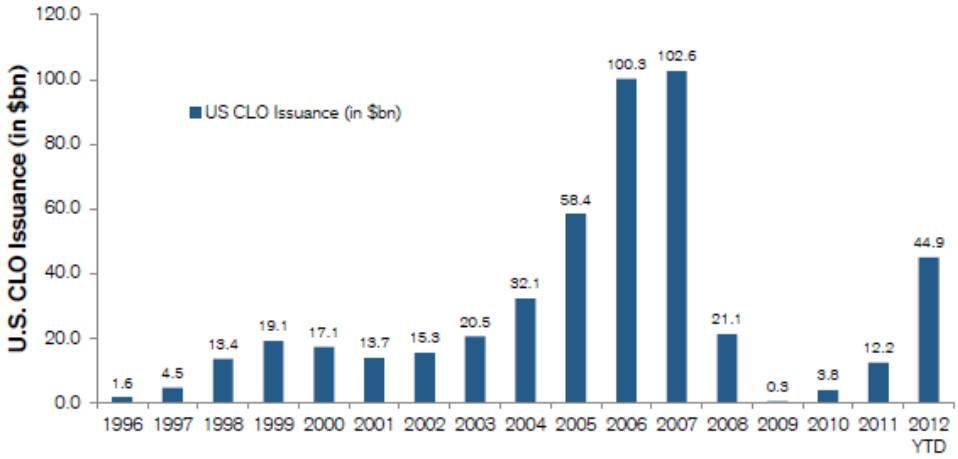
Risk taking has migrated back to the heady days of 'structured risk'. Recall these were the products with tiered levels of equity and credit underpinned with risky collateral whose high prices could not ultimately support the income required to justify those prices.

Leverage Loan Yield versus High Yield Bond Yield



Source: CSuisse

US CLO Issuance Rising



Source: CSuisse

This is a trend which will continue. David Zervos, our friend and former colleague from Greenwich Capital, rightly points out Fixed Income portfolio managers recognise that Ben Bernanke is embarking on financial repression, ie debt reduction via negative real rates, but know they will not be able to move into real assets, and that which includes physical equity capital.

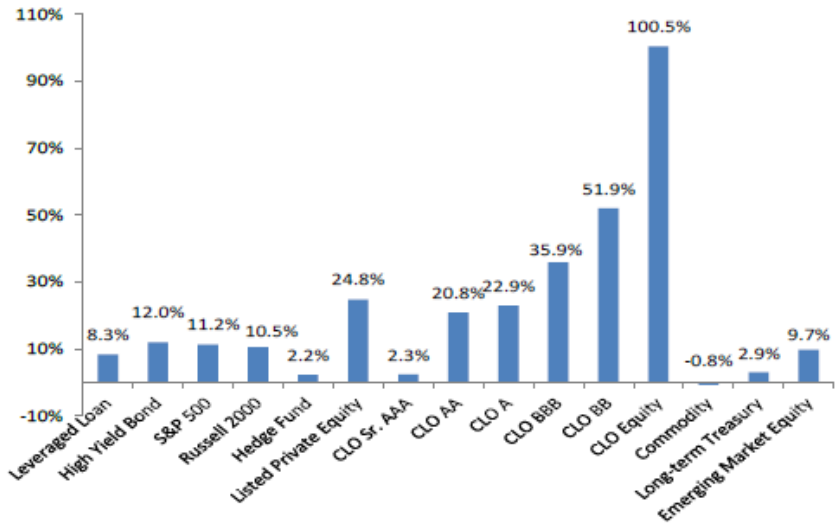
The only way they can minimize the damage of having to remain within investment constraints is to chase 'the return dragon' and invest in CLO-type structures. It's the beginning of the 2004 to 2007 'abracadabra' magical

merry go round ride of equity like fixed income investments all over again. Leverage is back. Gear up on "AAA" rated loan instruments supposedly based on 100s of loans, with the worst risk cut out and hey presto you have a riskless asset - default risk zero - until like Tyson you get hit in the face.

In time the synthetic CDS based CLOs will be back with a vengeance - money back guaranteed. Viva Las Vegas, well done 'Benny boy' your portfolio channel theory is in full swing until it comes unhinged once again with devastating consequences.

Although appetite will only grow, the degradation in the risk reward pay-off is clearly evident. Such leverage will get ugly in the next few years when it is evident the 'emperor was wearing no clothes'.

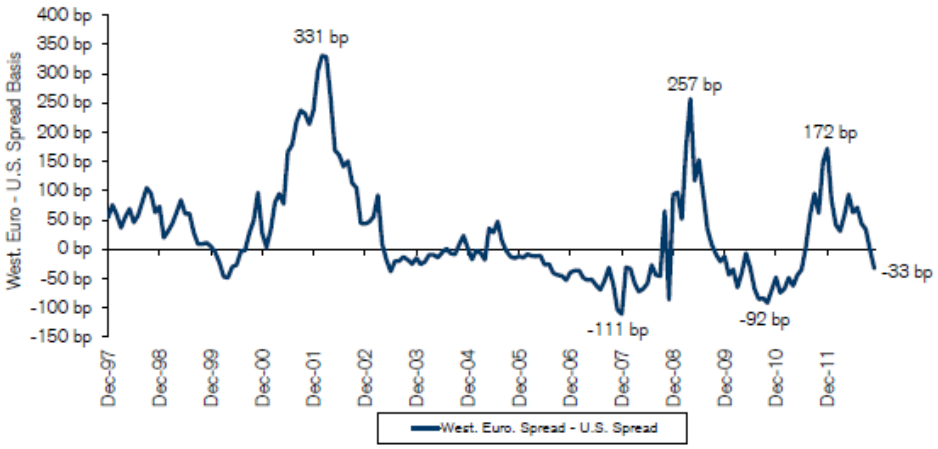
Total Return comparison of CLOs and other Risk(y) Assets (2012)



Source: CSuisse

European Risk less Risky than US?

Western European High Yield lower than US High Yield (spread-to-worst)

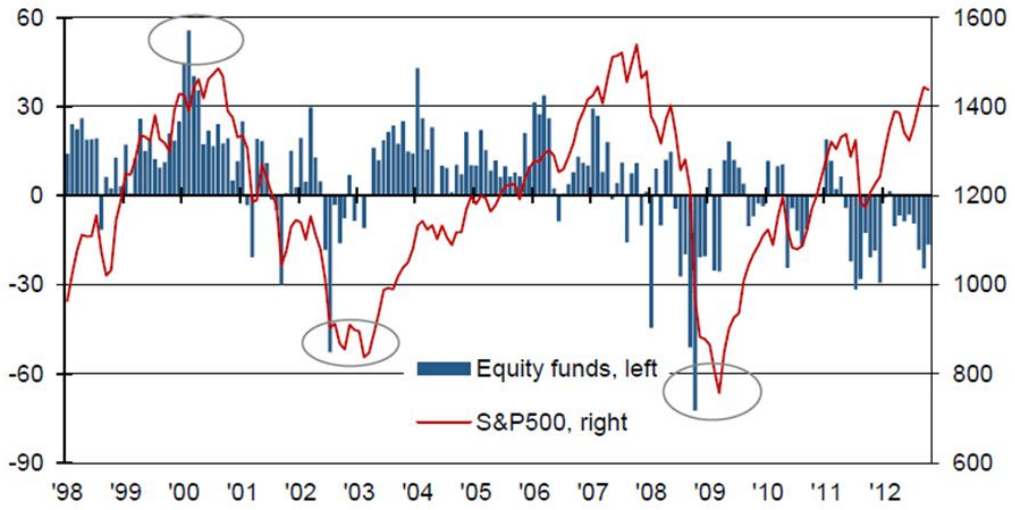


Source: CSuisse

Global Equities

Equity Fund Inflows vs SPX 2012

Monthly net mutual fund inflows ($bn)

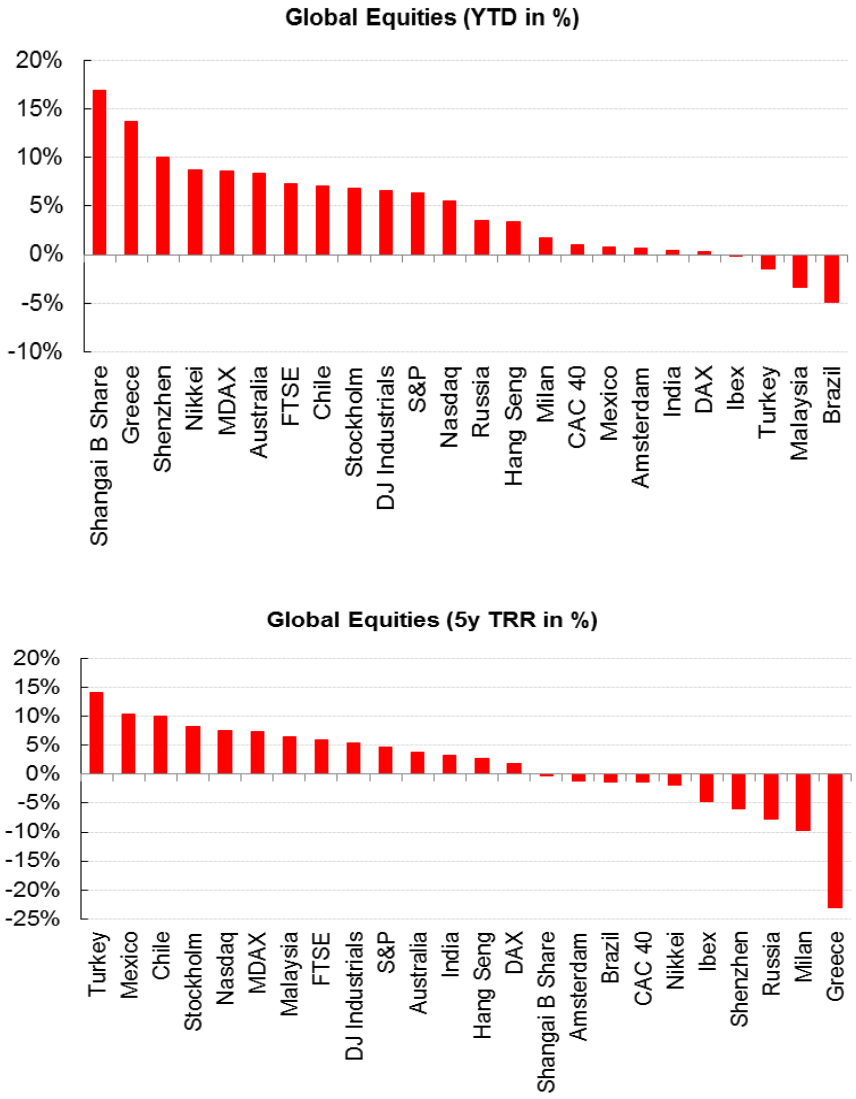


Source: CSuisse

In 2012 investors were wary of committing to the equity markets but equities still had remarkable returns. Clearly at the margin 'buying' agents have had more impact than sellers, or was this the manifestation of currency debasement on real returns?



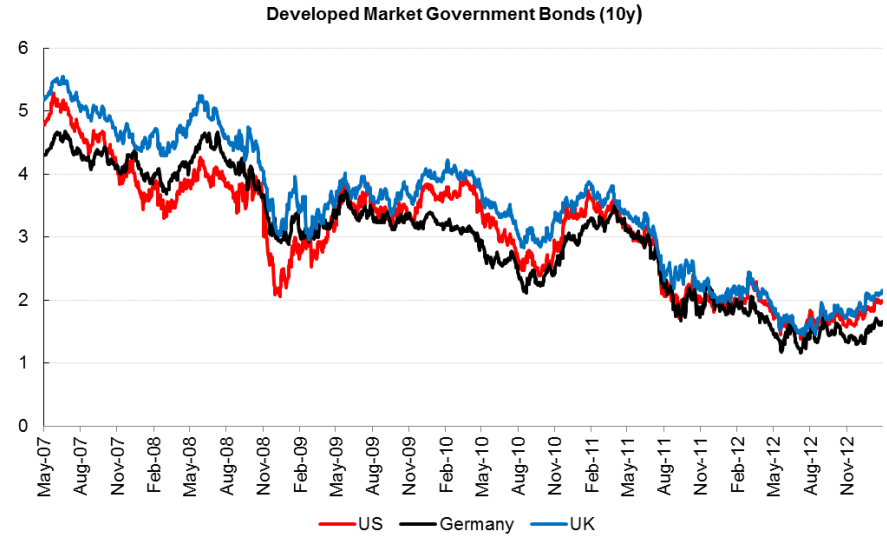
We would add that in chasing yield, investors have sort dividend paying companies, even spurning companies that are spending too much on capital expenditure, in favour of companies who provide said dividends. This obviously is not a positive outcome for long-term health of the economy if investment is treated with such disdain.

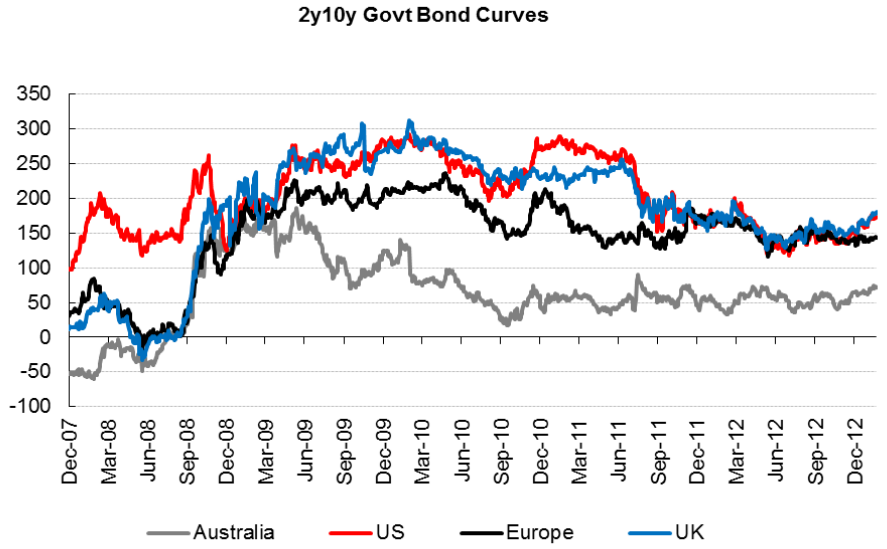


In fact developed market interest rates in the long end have begun to rise, as we discussed would be the risk. Yields have begun to rise as investors have been forced to boycott such low yields and search for return in comparable attractive equity yields. This was the true remote trigger in our opinion but the proximate cause one could argue was a function of both the perception of a sustainable and improving economy.

There has also likely been an acknowledgement of the fiscal risks to certain countries whose austerity and deficit financing behaviour is inflationary - such as the UK and Japan. Higher inflation rates and risk of fiscal incontinence equal higher long-end rates.

Developed Market Yields and Curve Steepening

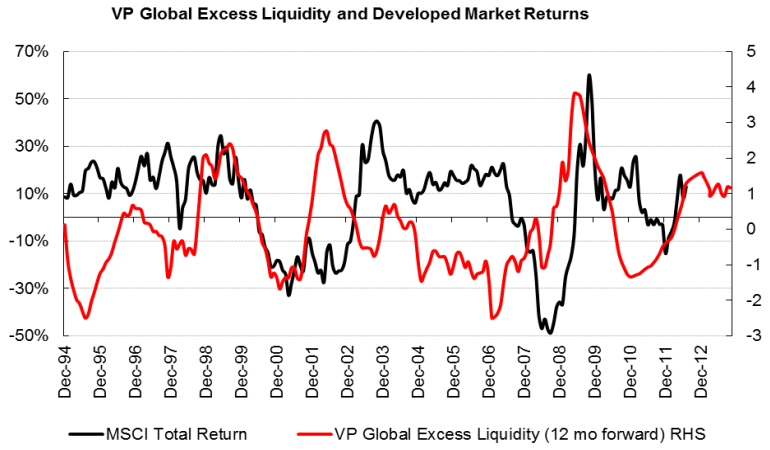




Equity Valuations Supportive or *relative* Valuation Trap

It was likely 2013 would start well for equity markets as investors have seen some uncertainties around politics temporarily resolved, ie seeming European break up risk downgraded and US fiscal cliff avoidance.

Nowadays investing has little to do with fundamentals and is all about liquidity. Our liquidity indicators have been supportive for a potential re-rating of equities and with little participation it takes little imagination to see how aggressively they could move in the first half of 2013.

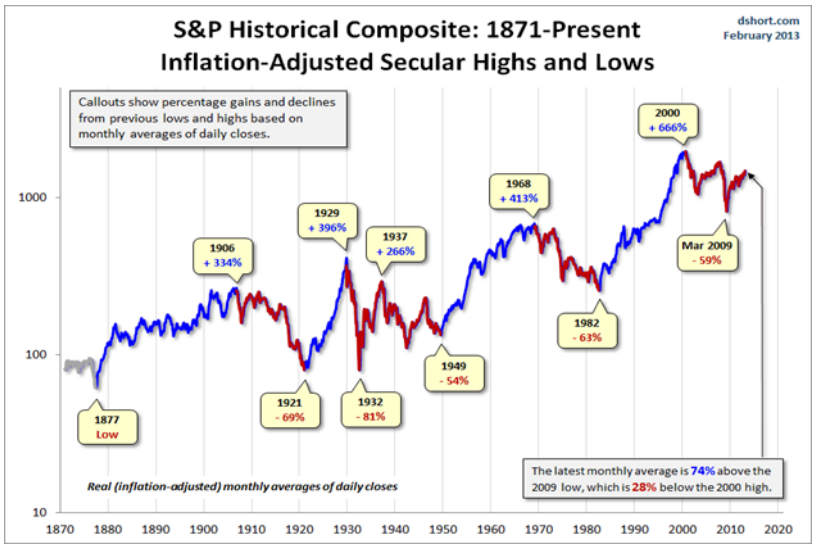


Source: Variant Perception

Real Austrian Monetary Supply (AMS) is growing 7% faster than nominal GDP, which suggests a 10 to 15% rerating of global equities.

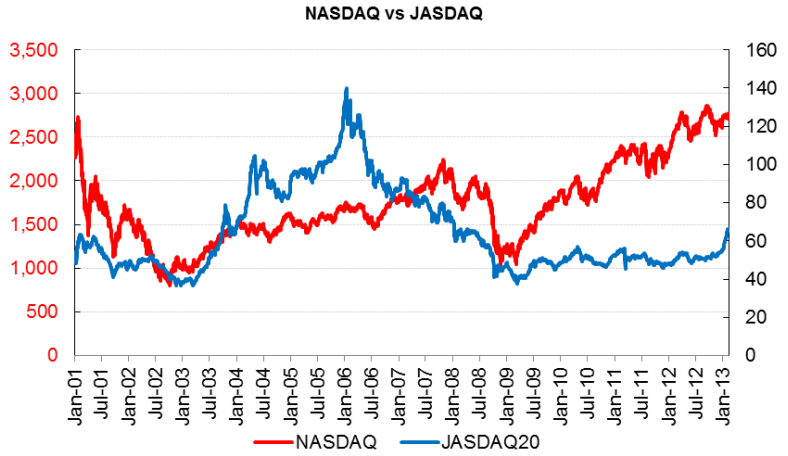
We have decided to participate in this re-rating by buying Japanese equities vs selling Nasdaq equities (expressed in directional volatility bets). The US has been in a bull market since the March 2009 lows and although we have long maintained that excess liquidity would underpin equities, we are concerned that investor euphoria will take markets up too fast too quickly, before another 'nominal' shock hits markets.

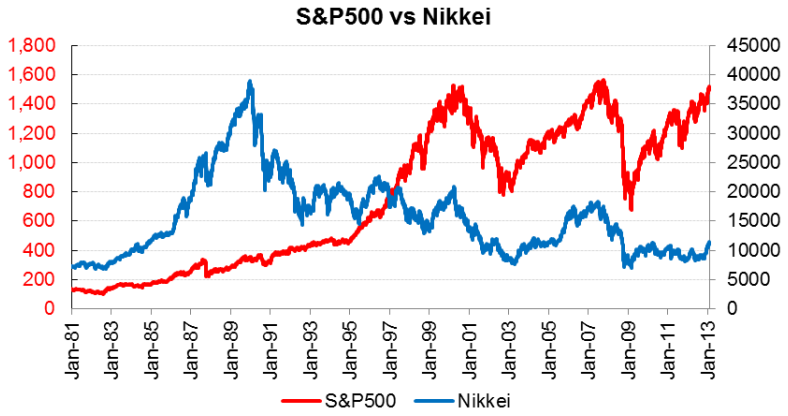
Equities have been trashed in 'real' terms this past decade but in nominal terms they have looked very strong. We suspect that more money units in the system will continue to help markets recover from mini-crashes.



Source: advisorperspectives.com

Japan Equities vs US equities

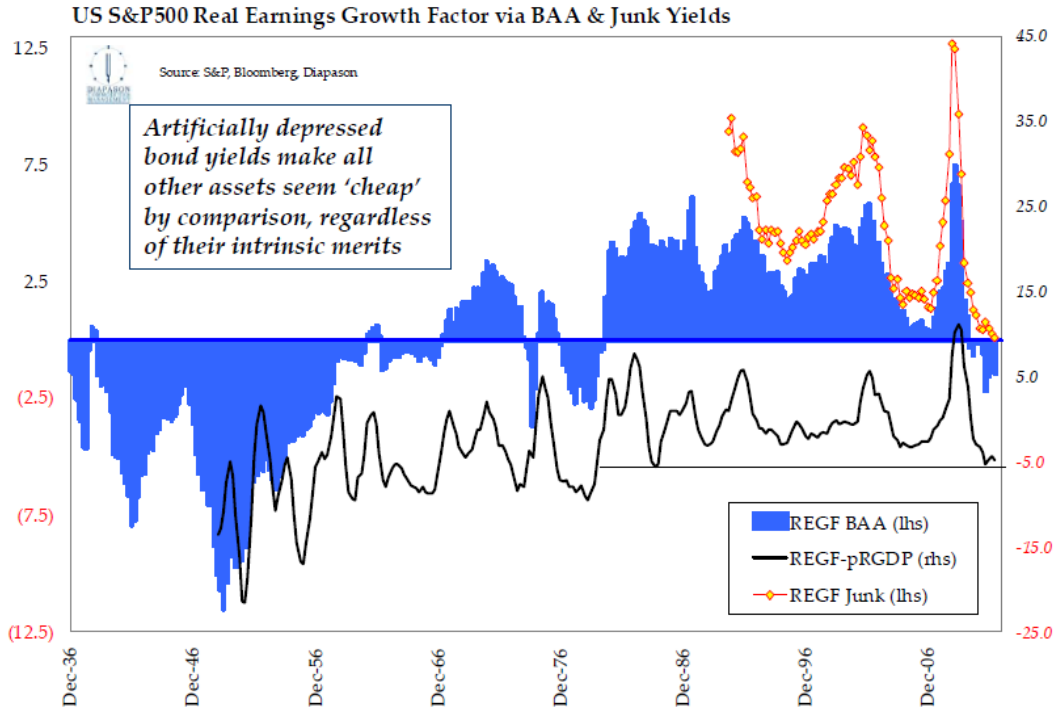




The on-going debate for us is will there just be a constant trend higher interspersed with precipitous but truncated falls as money begins to hyper-inflate all prices. The 'Zimbabwefication' of the global monetary system has kept us highly positive on equities but we have been selective, advocating EM equities such as Turkey and Vietnam. We want to rotate out of some of these tactically into our Japanese investments as there appears to be too much exuberance in EMs particularly.



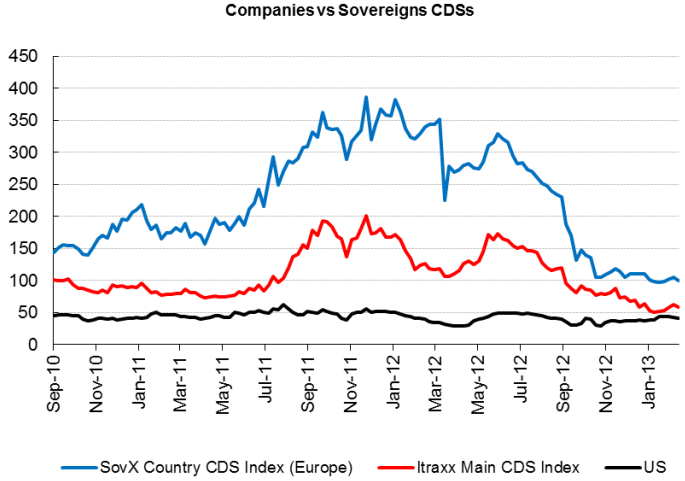
Portfolio managers have begun to look for companies paying consistent dividends, gauging that fixed income credit risk is too high at these low yields. Equity risk premium (ERP) which is the additional discount factor over government bond yields required to give a net present value of future equity returns is highly attractive according to Credit Suisse. It is 6.5% compared to a historical norm of 4%. Time to take some risks it would appear, but this is just a relative valuation due to excessively low bond yields. However, rates could back up to 2.25% for US ten year yields and the US ERP would still look attractive.



Source: Sean Corrigan, Chief Strategist - Diapason Commodities

Investors believe corporate balance sheets are in much better shape than government balance sheets. Is this priced in?

Corporate CDS trade lower than Sovereign CDS



Global earnings valuations look cheap:



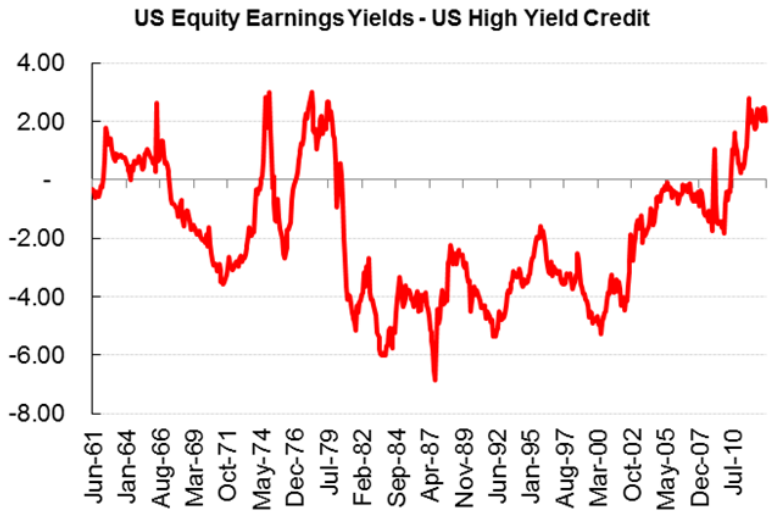
Source: CSuisse

But net income margins (US) are at all-time highs relative to their norm, (see Mind the *Margins* Gap section below). Globally they are not so high which is why we would look to own equities outside of the US.

Increased corporate issuance at such low yields will assist with the return on equity, as *only* leverage can do. But the long-term risks to balance sheets are then heightened. The risk to margins will ultimately come when wages start to rise. Until now labour pricing power has been non-existent.

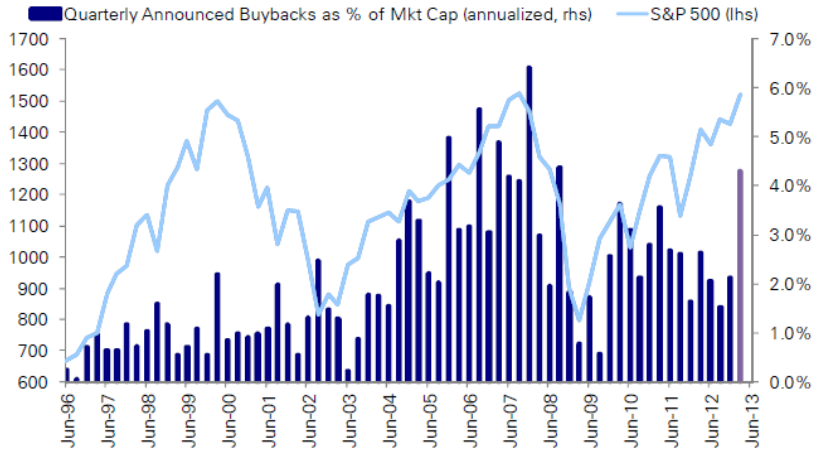
The relative value of equities to credit bond yields looks attractive on a yield and a return basis. If you are a portfolio manager who has benefited from High Yield (HY) bonds, you have made over 50% since 2008 and can rotate as Ben Bernanke would have you into an equity earnings yield at a record low valuation to such credit yields.

US Earnings Yield higher than Sub-Investment Bond Yield



The corporate sector has too much cash, so it is highly likely we will see a rise in buy-backs. Less stock outstanding with excess liquidity will likely support higher prices. S&P 500 firms have announced $80bn in buyback programs in 2013 alone, up 300% year-on-year and equal to over 4% of S&P 500 market capitalisation. This is an extraordinary rate. Bear in mind the whole of 2007, arguably the top of the boom, saw just over a 6% rate for the entire year.

Buyback Announcements as % of Mkt Cap of S&P 500



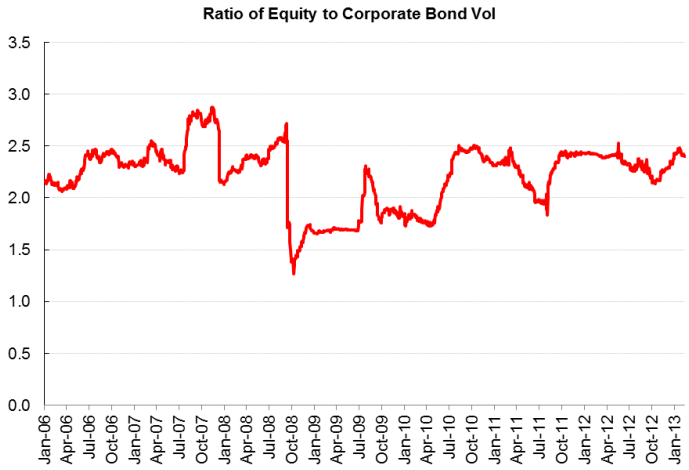
Source: Deutsche Bank

The risk appetite for equity has clearly been muted as flows into bond funds up until the end of 2012 had been at record levels on a relative basis.

Our overriding disquiet with this type of valuation analysis is that whilst it looks compelling it is based on the same delusional and misguided analysis that led to the inappropriate equity discount valuation of the 'naughties', and we know how that ended. Nothing has changed. Company balance sheets may have cash but they also have assets with distorted values on their balance sheets. Nonetheless we still need to understand how others in the market place view risk.

Equity volatility looks cheap relative to corporate bonds, close to an historical peak. But again this relative valuation methodology provides a false sense of security, if you excuse the pun.

Equity Volatility relative to Corporate Bond Volatility near Historical Peak

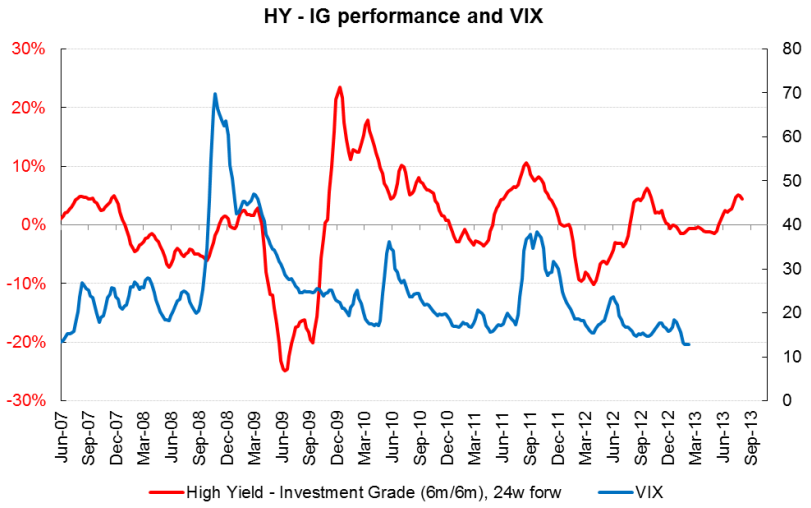


The risks to equities are bond yields. If volatility and rates rise in even a mildly disorderly manner, equity valuations will look highly vulnerable. **We would suggest, and it is mere conjecture at this point, that the sensitivity of equity margins to even 3 to 4% inflation rates, at this zero lower bound, is far greater than historically would be the norm.** Remember very high inflation levels such as those of the 1970s crush P/E multiples. We believe producers would have to raise wages in response to inflation this time around as marginal costs of labour are now rising globally. Usually a 4% inflation rate was highly conducive to more pricing power for corporations and margins remained intact or actual rose.

This is analogous to the real economy and interest rates. Real rates have had less and less ability to normalise at higher rates more reflective of the likely natural rate of money, because of the high levels of credit that could not be serviced at such rates. Hence rates have been held artificially low.

The next wave of price inflation we envisage could well lead to a clamour for labour price hikes, but even if this outcome failed to materialise, then household incomes would then not be supportive of sustained spending. Industrial production could not be supported by income and profits would fall.

It's all about yield risk to equity valuations. And yield risks are more a function of inflation than growth risks. If high yield spreads are turning, then we will likely see a rise in stock volatility which is associated with bear market risk.



Mind the *Margin* Gap

So are margins too high in the US? Yes, and here is why they may go lower.

1. Protectionist governments may require more tax revenue as profits as a share of GDP are very high.

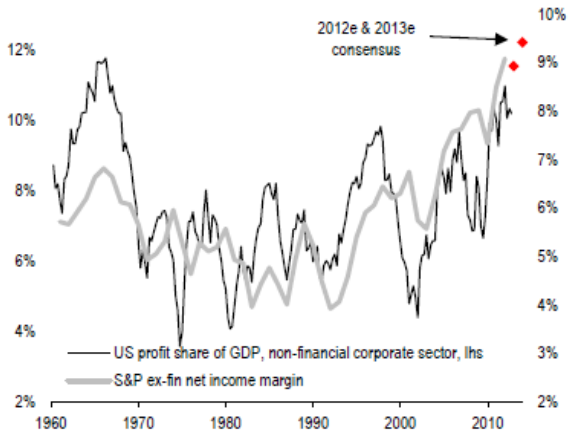
2. Corporate refinancing at low levels is done so there is no interest charge benefit in EBITDA.

3. Wage growth can only go higher.

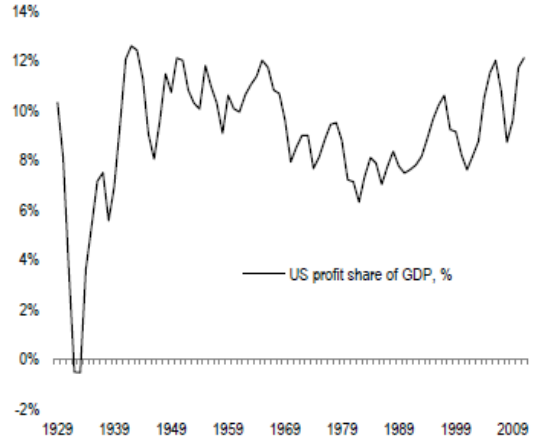
4. Capital expenditure and R&D could rise in response to *virtual* signs of growth emitted by price rises born not out of real demand but credit supply. This will eat into margins as depreciation charge on capital stock will rise.

5. Oh, and there is no *real* growth in economies, so hampered are they by too much credit, ie debt.

US Margins as % GDP very high



Margins at pre-WWII high

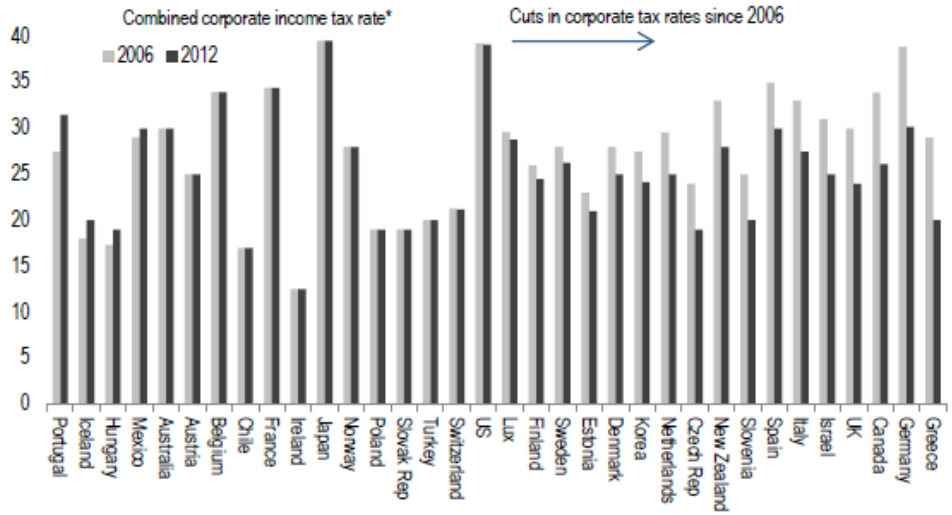


Source: Deutsche Bank

An over-indebted nation such as the US will find such profits too an attractive proposition not to confiscate. It may be too much for Obama, 'Mr Socialist' himself, not to levy higher taxes on corporations, especially as many US companies use their multinational status to 'avoid' as much tax payment as possible through legitimate loop holes.

Although corporate tax rates have fallen as countries have competed with each other to attract overseas investment and encouraged companies to locate away from home, this was a trend that began before the crisis hit. The risk of more protectionist legislation to keep that revenue at home seems likely to increase, not by encouraging lower tax rates but by just demanding overseas tax payments be remitted home. Desperate times call for predictably desperate measures.

Corporate Tax Rates began falling in 2006



Source: OECD, CSuisse

Emerging market gross margins are lower than 1995. This is as far back as data allows, just prior to the Asian and EM bubbles. Of course they are merely a function of lower interests, depreciation and tax charges which have fallen. Again if rates stay low then margins remain attractive for investors to take on equity risk.

Earnings Margin

US	16.7%	16.5%	0.10
World	15.2%	15.4%	-0.20
Euro Area	14.4%	14.7%	-0.20
Japan	9.9%	10.7%	-0.70
UK	15.1%	16.4%	-0.90
Emerging Markets	16.3%	20.2%	-2.00

Our US equity short play of technology stocks (versus long Japanese equities) is partially born out of the excessively high margins the sector exhibits relative to any other time; and this is a sector that has few barriers to entry. (See US Sector Margins on the next page).

US Sector Margins

Tech	24.3%	19.3%	1.20
Consumer Services	11.4%	10.0%	0.90
Oil & Gas	18.6%	16.5%	0.90
Market	17.9%	16.8%	0.70
Market ex tech	16.6%	16.0%	0.40
Healthcare	18.6%	18.4%	0.10
Basic materials	16.8%	16.4%	0.10
Utilities	28.8%	29.2%	-0.10
Industrials	15.4%	15.7%	-0.30
Consumer Goods	13.6%	15.7%	-1.20
Telecom	25.6%	34.3%	-1.80

With wage growth historically so low and although we envisage a period of continued low growth, we do not believe prices will remain stable enough not to see labour cost pressures rise. Skilled workers will demand 'greedy' companies return some of that margin, and with EM wages rising, competition from abroad is diminishing. To boot, domestic governments are becoming more isolated in nature, promoting protective legislation that makes this less an option. It is considered unpatriotic.

US Wage growth & EM



The long-term average US wage growth since the 1980s is 3.7%, so 1.6% looks unsustainably low. It would take many months for such labour rises to cut into margins, but couple this with higher rates and can they remain as high as they are, supporting equity levels?

If capital expenditure rises and depreciation levels go up the offset is the return on that capital. If sales growth rises with central banks push on nominal GDP (NGDP), then margins could stay high. Remember NGDP is real growth plus inflation, so if central bank's target NGDP, then we would argue they are more competent at creating the latter rather than the former. Higher inflation will not be good for margins.

Real Assets - Commodities vs. Equities

Real Industrial commodities are at an apex in price and with ***the central bank revolution*** underway we expect to see this apex sustain a trend to the upside and this in the face of an overhang of stockpiling and record levels of output in some industrial metals. There has been overinvestment and overcapacity as the BHPs of this world have over committed to the China 'growth' miracle.

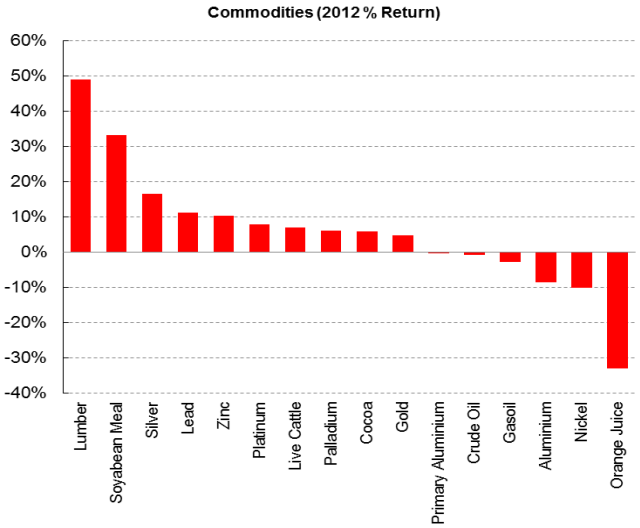
DCI Commodities at a price apex

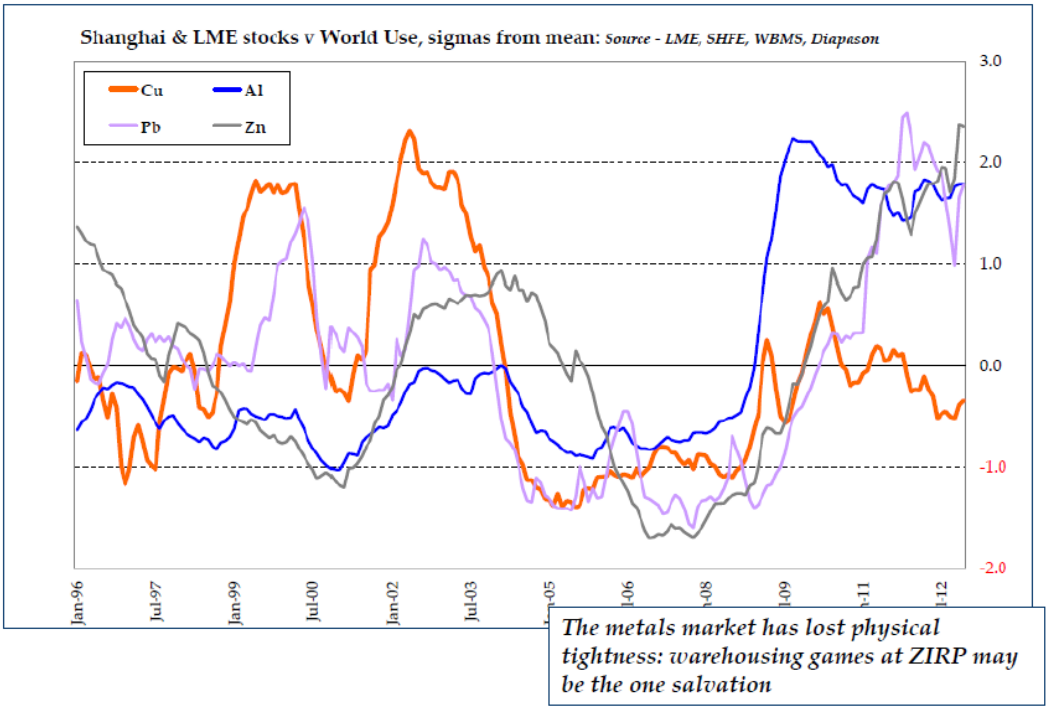


Source: Sean Corrigan, Chief Strategist - Diapason Commodities

This entails investors should be more selective in which commodities they purchase. The PGMs are lacking available supply whilst nickel and aluminium have over supply, but we would also say that the prices of the latter commodities likely reflect this, having performed badly as an investment return this past few years. Stockpiling outside the exchanges is likely higher as China has an opaque system of state funded depositories.

Commodity performance 2011 - 12

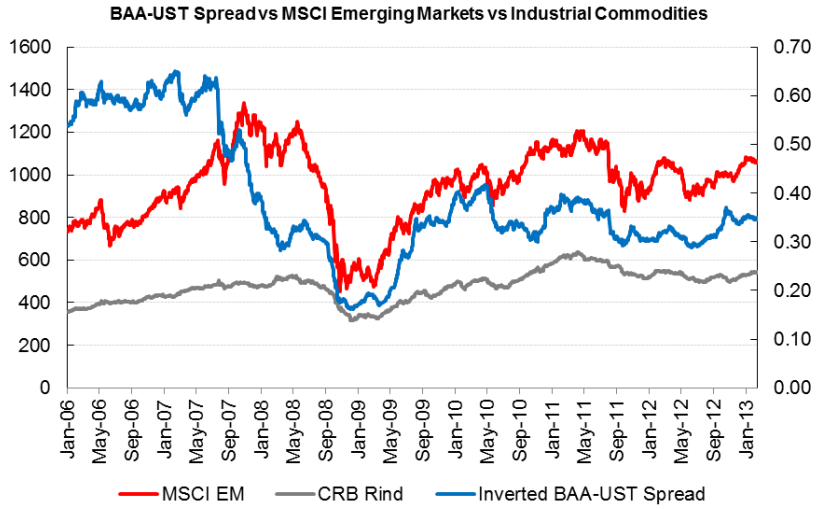




Source: Sean Corrigan, Chief Strategist - Diapason Commodities

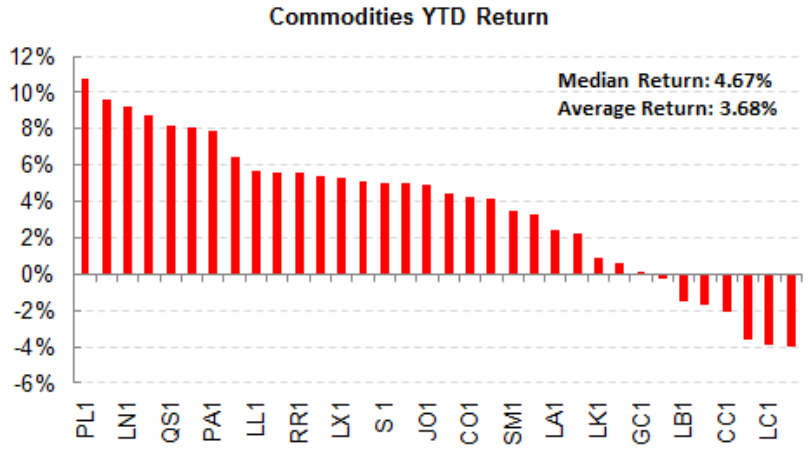
As readers may have read in our HindeSight letter - Commodities - The Myth of Commodity Diversification, if you are investing in equities, you are likely investing in the same economic drivers - industrial commodities. However, if commodities start rising at a faster rate than growth, which is what we expect then equity markets will come off second best to certain commodities.

MSCI EM vs Industrial Commodities Chart vs Inverted BAA-UST spread

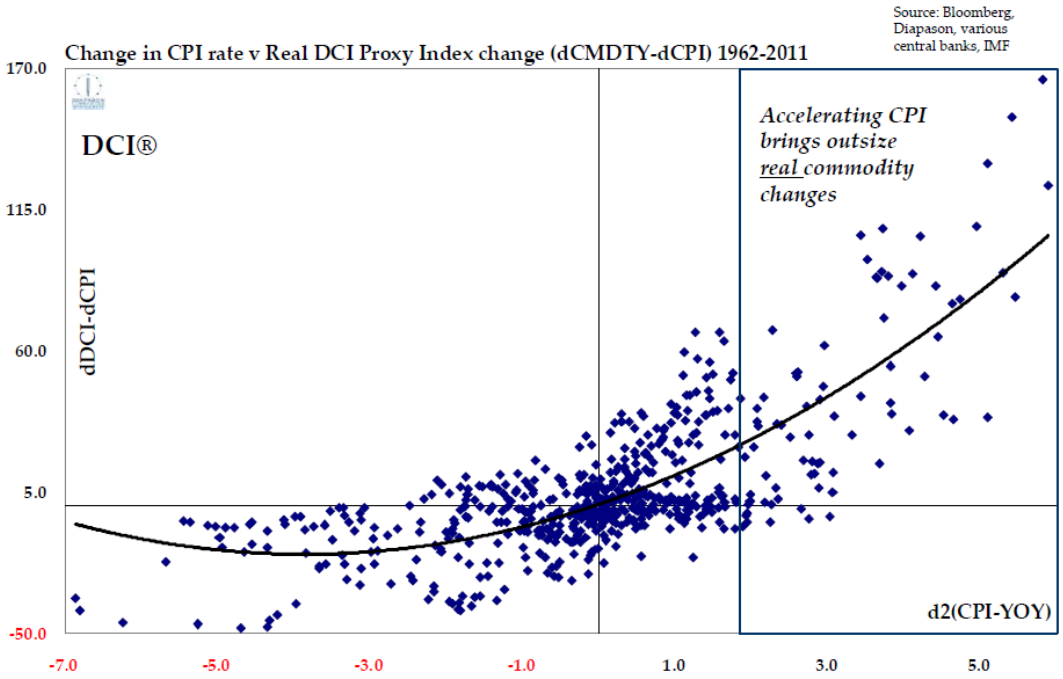


Indeed, commodities have responded well, very much in line with equity performance.

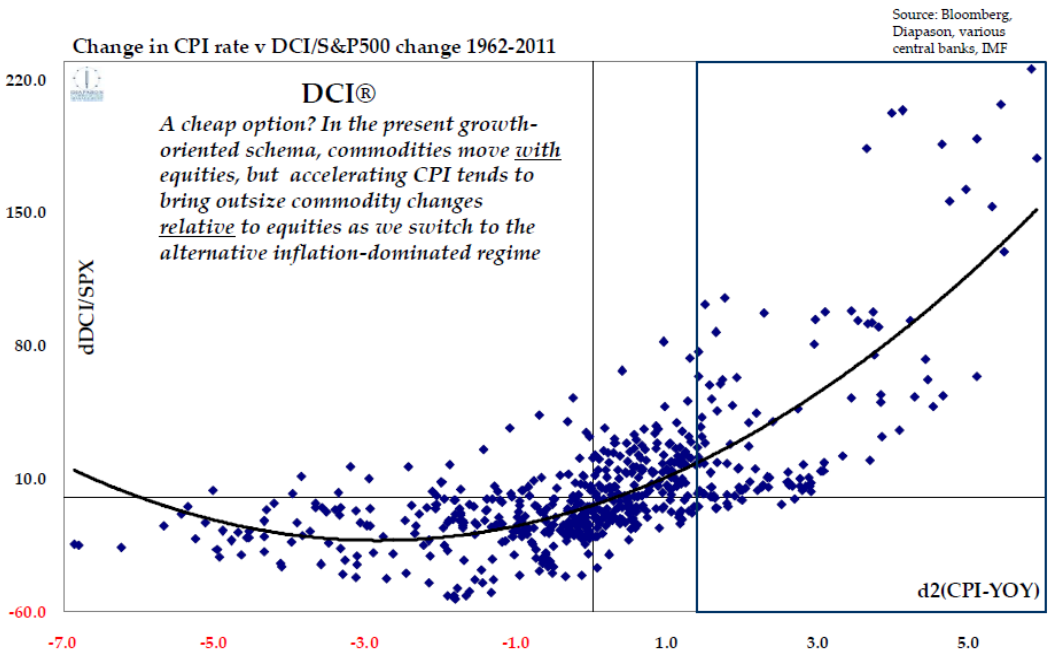
Commodity Performance 2013 YTD



But will they outperform? To reinforce our point we wanted to use some graphics by Sean Corrigan, Chief Strategist for Diapason Commodities Management. Like Sean we believe that commodities will move with equities but as CPI begins to accelerate we believe there will be outsized relative performance to equities as finally the inflation-dominated regime surpasses real growth.



Source: Sean Corrigan, Chief Strategist - Diapason Commodities

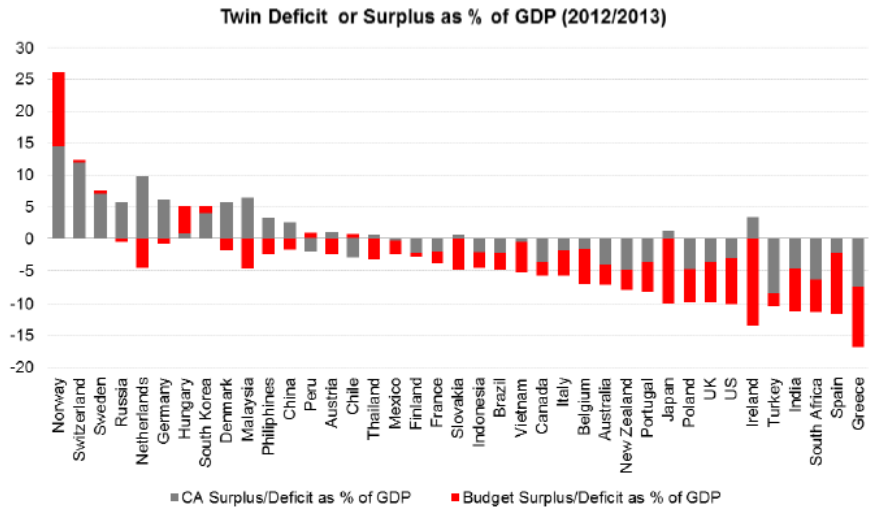


Source: Sean Corrigan, Chief Strategist - Diapason Commodities

FX Regimes and Gold

Expected returns in an environment of high inflation depend on which asset class you venture into. FX volatility will likely rise as global currencies in the developed world devalue back and forwards against each other in a globally coordinated devaluation which could become a real currency war. We say this, because currently countries have generally agreed to a set of devaluation rules whereby if one devalues too much then they must stop and allow others to devalue. If gaming theory applies to currency policy, then we suspect one or more countries will devalue more than they loosely agree to, in order to gain a competitive advantage.

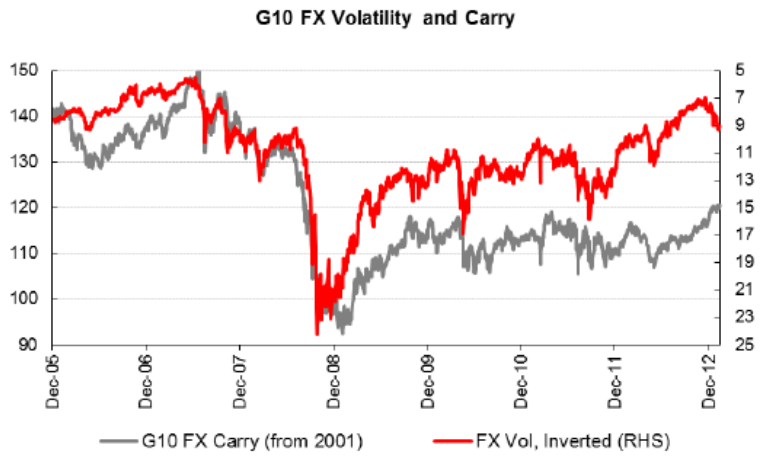
One chart that macro investors should always keep close by is the following one which depicts the size of twin deficits (sum of current account and budget balance as % of GDP) for global economies.



Source: Variant Perception

A large twin deficit does not in itself pose a significant macroeconomic risk, but it provides an important initial warning sign. It is highly likely that those countries with poor external funding and too much gross debt will tend embark on more QE which will result in falling currencies. Indeed countries which have expressed a desire to reflate, have seen their real effective exchange rates (REER) fall sharply and their FX volatility has risen.

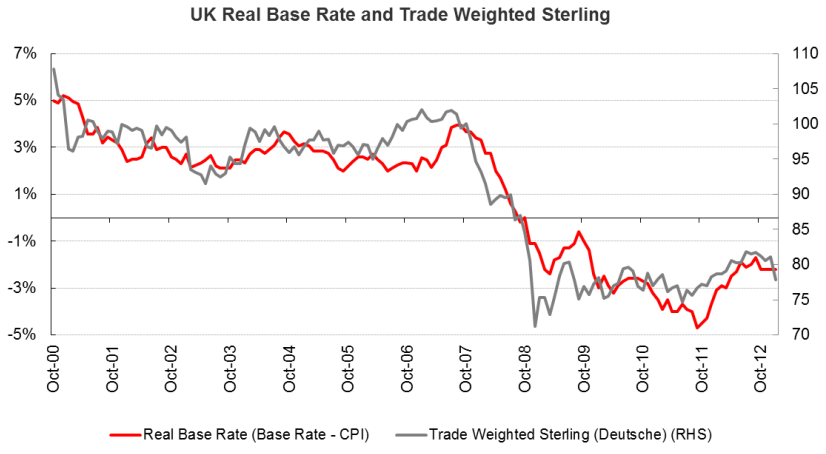
The regime change at the BoJ and an activist government has led to the yen plummeting in value as 'Abenomics' inflationary politics takes hold. This has led to a sharp rise in JPY volatility. Rising volatility also increases the risk for carry trades.



Source: Variant Perception

Japan is the first of the developed countries to reach the mathematical end point whereby their long-term debts can never be repaid and where only the central bank can service the debts by purchasing government debt at extremely low yields. The alternative is to stop buying and let the fiscal gap explode, then, yields would rise catastrophically as recognition that Japan was finally bankrupt. Japan is bankrupt and the collapse in value of the yen over the next few years will be a testimony to this reality as hyperinflation will likely manifest itself. We will revisit Japan in future HindeSights.

Similarly, investors in the UK have depreciated the UK REER in response to fears of fiscal rectitude and the inflationary gamble the new BoE governor, Mark Carney, has implied he will undertake.

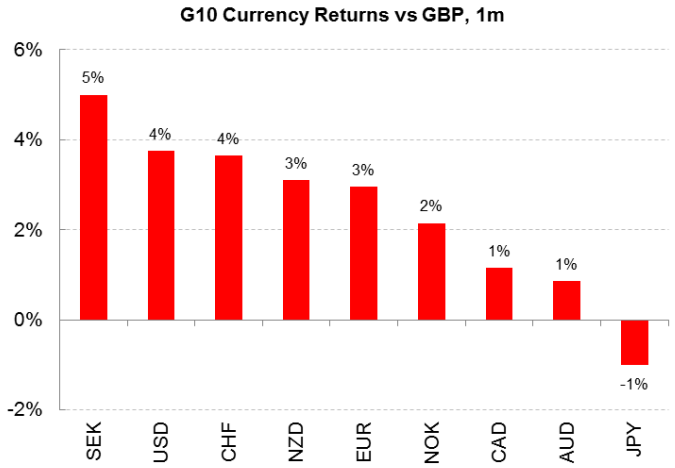


The commensurate rise in sovereign debt levels will see the UK witness the continued presence of the BoE in the gilt market but this does have important psychological limitations. Investors will become increasingly perturbed at the use of printed funds to service the UK debt situation and will want compensation in the form of higher returns to cover potential inflationary implications.

We stated in our Eyes Wide Shut series last year that:

"There is an ever present and real danger that the debts of the UK will not be tolerated by financial participants. The UK faces a very significant debt issue which threatens to become a full blown sterling crisis."

At the time we also stated *"This is clearly not an eventuality that markets are currently assigning any probability."* Well domestic and overseas investors alike are now beginning to recognise the risks:



Gold Monetisation (Un)Official

"As the international community attempts to take on these challenges, gold waits in the wings. For the first time in many years, gold stands well prepared to move once more towards the centre-stage. This could be the start of an immensely important phase in the history of world money."

This is a quote taken from the OMFIF, (Official Monetary and Financial Institutions Forum) report, Gold, the renminbi and the multi-currency reserve system. **This is a significant release because it is an acknowledgment by policymakers through an *unofficial* channel that there is real concern about a breakdown in the global monetary order.** We had not come across the OMFIF until this report was released. The OMFIF appears to be a supranational advisory group set up as a consequence of the crisis and they describe themselves accordingly:

"The Official Monetary and Financial Institutions Forum (OMFIF) is formed around a core of public sector asset and reserve holders at the heart of world finance. Central banks and sovereign wealth funds play an ever-growing role in international economic management, undertaking activities that require a high degree of confidentiality and discretion. At the same time, they need thoroughgoing interaction with the private sector to help improve their performance and tackle a variety of old and new tasks.

OMFIF goes to the root of the challenges confronting the world economy by providing a convenient yet discreet means for high-level financial market dialogue aimed at controlling risks and enhancing prosperity. OMFIF's activities are crystallized around two essential areas: improving the effectiveness of individual public sector institutions through better asset and liability management; and increasing the cohesiveness of the new supervisory and regulatory arrangements."

"The OMFIF offers a confidential, convenient and discreet forum to a wide-ranging group of central banks, sovereign funds, financial policy-makers and market participants who interact with them…."

It does appear to be a 'club' like environment by which central bankers, financial leaders and institutional asset managers can debate issues that face the global financial markets. It follows a code of practice similar to the Chatham House rules – where open dialogue remains behind closed doors. It's not clear to us the exact 'agenda' of this group.

The actual Gold, the renminibi and multi-currency reserve system report acknowledges that the days of a single reserve currency are over, and that the US dollar reserve currency hegemony is finished. John Butler, the author of the Golden Revolution, wrote a very good interpretation of the report - Countdown to the Collapse and we would largely agree with him.

Developed nations clearly alarmed by the accumulation of gold in official reserves by the BRICs, see this as a potential challenge to the current monetary order. The OMFIF recommends gold should have a formal role in the monetary order, by inclusion in the Special Drawing Rights (SDRs) basket as calculated by the International Monetary Fund (IMF). The SDR is currently a global reference point for currency valuation and IMF member countries' capital shares are denominated in SDRs.

The report acknowledges that developed countries "have attempted to dismantle the yellow metal's monetary role…Gold thus stands ready to fill the vacuum created by the evident failings of the dollar and the euro, and the not-yet requited ambitions of the renminbi."

Irrespective of the recognition of gold and fiat currency failings it suggests that gold should be given equal status to other major fiat currencies, which they recommend should include the 'R' currencies – renminbi, Indian rupee, Russian rouble, Brazilian real and SA rand. Butler suggests this is an olive branch to appease the developing countries and an offer to be part of a global currency system based on the SDR with gold.

We see the multi-currency reserve system as potentially a confidence trick played against the BRICs, one which we are sure they see through. The acknowledgement of gold in this fiat currency basket is a red herring. Its potential is merely to entice BRICs to partner in keeping the global fiat currency system intact, albeit with less weight to the US dollar. Likewise it could be a confidence trick against electorates around the world. If a new global monetary order develops based on the SDR which is highly possible, as there is already a blueprint for a bond market based on them, (for how else can the IMF create SDR units), then it is merely a smoke-screen introducing gold into the basket to stabilize any untoward excess currency creation. It's a smoke-screen because the gold would not be paid ever. As Butler notes –

"…extending the SDR to include the R-currencies – the renminbi, rupee, real, rand and rouble – with the addition of gold. This would be a form of indexation to add to the SDR's attractiveness. **Gold would not need to be paid out, but its dollar or renminbi or rouble equivalent would be if the SDR had a gold content.** By moving counter-cyclically to the dollar, gold could improve the stabilising properties of the SDR. **Particularly if the threats to the dollar and the euro worsen, a large SDR issue improved by some gold content and the R-currencies may be urgently required."** (Emphasis added – see pp. 4 of report.)

Irrespective of the motivations of the report it clearly reveals that a solution to the monetary system, including gold, has been discussed at the highest level. But it reinforces a number of our thoughts. First it reinforces all the conversations we have had with monetary institutions in Asia, and the case we have made for a number of years that China (with assistance of some other BRICS) was embarking on renminbi liberalization which they would ensure could be fully fungible with gold. Secondly it reinforces the very real and palpable fear by Western countries that their fiat currency regime is under threat. We are witnessing the evolution of a new West versus East war – the Gold War.

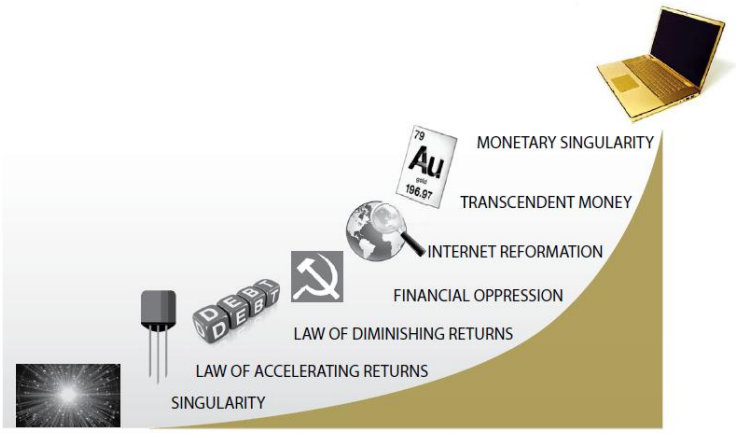
The Cold War may have ended but its successor is the Gold War. The BRICs have had enough of the 'exorbitant privilege' afforded the USA by its currency's reserve status. They are realigning their financial

systems with gold and embarking on bilateral trade agreements that exclude exchange in dollars. Those countries which successfully remonetize their currencies and reserves to gold will potentially create nations that focus on growth through productivity gains rather than by artificial growth from credit expansion which cannot be funded in the long run. These countries will be geopolitical strong and able to fund their resource needs much more easily.

Monetary Singularity

It is evident that certain global actors are trying to contain the growing demand for gold as an alternative reserve asset, so as to prevent an uncontrolled gold remonetisation. However in our Singularity – Transcendent Money presentation Ben Davies attested to the potential for the free market monetisation of gold. He termed the outcome a *Monetary Singularity*:

> "The collapse of an old monetary system and its social order will momentarily may well give way to anarchic and chaotic behaviour. But I believe there are two sides of a coin that make it a unit. A singular event such as anarchy will be mirrored by order. One money will be dead the other alive. These are but flip sides of the same coin.
>
> We will witness what I term a Monetary Singularity - a unique event. This is the point where technology and gold merge. Technology will enable the transactional use of gold as money in the world.
>
> To date technological evolution by the paradigm known as the World Wide Web has begun to help create awareness of the diminishing value of paper money.
>
> The growth rate of this awareness will become exponential and equal and opposite to the exponential demise of the fiat currency system. The more awareness grows the faster the discarding of paper money occurs. I consider this a positive feedback loop because this takes us nearer to the day we can begin a sound monetary system dictated by the free market fundamentals of supply and demand of money. And not those of the artificial supply set by government, which destabilises the 'slope' of value of money.
>
> The inverse function of this paper demise is the commensurate rise in the gold price, as we have depicted. This process of destruction will seem almost imperceptible, but when we hit the "knee of the curve" in monetary failure and gold succession, the perception will seem immediate."



Source: HindeSight Letter: Singularity – Transcendent Money

Policymakers would be extremely concerned at a rapid and uncontrolled rise in the price of gold, which is why GATA's work, love them or hate them, just like "Marmite", just like gold, is uncovering the true nature

of policymakers attitude to gold. We suspect that if the new Central Bank Revolution fails to restore equilibrium to the world as we believe it won't, then the most likely course of action for them as to allow for a restatement of unreserved bank obligations with gold.

So it is quite possible that gold will truly only rise to reflect its true value when it is in the interest of policymakers to allow it. However this will not be a smooth process as the more an entity invokes price controls, the more demand rises relative to supply at artificially suppressed prices. So as policymakers arrest the appropriate ascent of gold, so free market demand will rise relative to available supply and prices will begin to rise aggressively, with or without official consent.

Official balance sheets already own gold and are accumulating more. Bank regulation is changing to enable collateralisation and liquidity provision with gold; although it has a ways to go, but it at least has created a legal application of gold in the system should governments reassign gold to the currency system in an official capacity. The loosely coordinated efforts of rotating currency devaluation and its attendant currency creation are leading to a loss of *faith* in the validity of money and credit. Reattachment on the asset side of central bank and bank balance sheets by physical gold will restore rude health to all economic agents – sovereigns, corporations, small businesses and households. This reattachment or backing would entail much higher prices in gold to fully back unreserved bank obligations (and those of the shadow banking sector).

Remember government bonds replaced gold as the asset or collateral that underpinned the financial system so if bond rates start rising in a disorderly manner because of inflationary fears then this move higher in real rates is actually a signal of gold performance.

We would simply state that:

The Money Bubble = Bond and Currency Crisis = Gold Outperformance

Postscript

The Dragon is alive and well and any investor who chooses to chase the dragon will be looking for a nirvana they can never attain. The more they chase the greater the risks befalls their portfolios, but more alarmingly the greater the excesses created the greater the instability that befalls the global economy.

Nations sustain prosperity by encouraging an openness of society, willingness to permit creative destruction and democratic rule of law. It is the relationship between man-made economic and political institutions that fosters these aspects of the nation. Those institutions that promote real growth through productivity enhancement and encourage progressive innovation will thrive, as opposed to those that move towards repressive institutions of the State, who will stagnate and fail.

Unfortunately this is where most developed countries are heading today. Mounting debt that has merely boosted government consumption and transfer payments has undermined the overall productivity growth and has led to economic stagnation and *loss of economic freedom.* Unfortunately, we believe that a nation will tend to bankrupt its citizens before it bankrupts itself; especially under a fiat currency system when it has the temptation to fund a welfare state through continued deficit financing. This is the case today.

Friedrich Hayek in *The Road to Serfdom* wrote:

"To build a better world, we must have the courage to make a new start. We must clear away the obstacles with which human folly has recently encumbered our path and release the creative energy of individuals. We must create conditions favourable to progress rather than "planning progress."... The guiding principle in any attempt to create a world of free men must be this: a policy of freedom for the individual is the only truly progressive policy."

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